Supreme Court, U. S.
FILED
AUG 18 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 77-275

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER III,
Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners, Arthur Lipper Corporation, an investment banker and a securities brokerage firm which was a member of the New York and other national securities and commodities exchanges, and Arthur Lipper III, its president and principal stockholder, respectfully pray that a writ of certiorari issue to review a judgment and opinion of the United States Court of Appeals for the Second Circuit. The Court of Appeals (1) affirmed an order of the Securities and Exchange Commission ("SEC") that found Petitioners had

aided and abetted IOS Ltd., a non-United States investment manager of a group of non-United States investment companies, in arranging brokerage practices which violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78(j), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, and (2) modified the SEC's sanction by reducing Petitioners' permanent expulsion from the securities business to a retroactive 12-month suspension. Petitioners seek a writ of certiorari solely to review (1)—the SEC's determination that Petitioners aided and abetted violations of Rule 10b-5.

OPINIONS BELOW

The opinion of the Court of Appeals (App 1a) [1] is reported at 547 F.2d 171. The opinion of the SEC (App 29a) is unreported.

JURISDICTION

The judgment of the Court of Appeals was entered on December 10, 1976, a timely petition for rehearing filed by the SEC was denied on March 22, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a securities broker can be found by the SEC to be an aider and abettor in a deception violative of the SEC's Rule 10b-5 where the broker, in good faith and upon advice of qualified counsel, executed securities transactions in compliance with instructions of the broker's institutional customers (such

[1] "App——" refers to pages of the appendix of Petitioners.

instructions being customary and in accord with prevailing securities industry practices) without determining whether the institutional customers and their investment manager had abided by their fiduciary responsibilities.

2. Whether the SEC can export to and impose in foreign lands its interpretation of American legal concepts of a "gross breach of fiduciary duty" (App 41a) so that Rule 10b-5 duties are imposed upon relationships between foreign investment managers and foreign investment companies and their shareholders.

3. Whether due process is denied where the SEC is not required to shoulder the burden of introducing evidence in an administrative proceeding charging Petitioners with manipulative and deceptive practices.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78(j), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, are set forth in the Appendix, p. 74a.

STATEMENT OF THE CASE

This case is a further chapter in the SEC's continuous attempts, with the support of the Second Circuit courts, to expand a rule of law of the SEC's own creation, namely Rule 10b-5. The expansion of Rule 10b-5 in this case is twofold: (1) for the first time a securities broker is required (at the risk of being found an aider and abettor) to determine whether its unaffiliated institutional customers and the customers' investment manager are engaging in a breach of trust and (2) novel American concepts of fiduciary duties are

imposed wholesale to corporations incorporated and conducting business outside the United States.

Petitioners were found to have been secondarily liable as "aiders and abettors". The primary violator was said to have breached its fiduciary duty. The fiduciary was IOS Ltd., a Swiss-based, Panama incorporated investment manager of a group of foreign mutual funds, namely The Fund of Funds Ltd., and Regent Fund Ltd., two Canadian investment companies, and IIT, an investment company organized as a Luxembourg Trust. The *cestui que* are the shareholders of those foreign funds.

The breach of trust involved brokerage arrangements existing between the foreign investment companies and Petitioner Arthur Lipper Corporation, an American securities firm which was a member of the New York Stock Exchange ("NYSE"), other national stock exchanges and the National Association of Securities Dealers ("NASD").[2] Arthur Lipper Corporation was conducting an institutional brokerage business during a period of extended controversy among the NYSE, institutional investors and the SEC. The controversy involved such fundamental questions as justification for the very existence of the NYSE and, of particular relevance here, the amount and manner in which its members were compensated.[3]

The institutional brokerage practices challenged here by the SEC were the methods whereby members of the NYSE, who were acting as brokers in executing

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[2] The NASD is the self-regulatory association organized under Section 15A(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3.

[3] See *Gordon* v. *New York Stock Exchange*, 422 U.S. 659 (1975).

transactions, were permitted to share, at their customers' direction, commissions with other members of the brokerage community, provided none of the commission dollars were shared with members' customers, *i.e.*, so-called give-up practices. During the period in question, 1967-1968, it is uncontested that give-up arrangements pervaded the entire securities industry. These years as the court below noted:

> . . . were years of considerable uncertainty as to the climate concerning give-ups; the Commission was torn between its desire to move away from uniform fixed commission rates, a movement which would eliminate the economic basis for customer-directed give-ups, and its belief that existing give-up opportunities should be utilized by investment advisers for the benefit of shareholders in mutual funds. (App 24a)

The salient facts are few and, for the most part, never in dispute. Arthur Lipper Corporation was organized by Arthur Lipper III to engage in an institutional securities brokerage business. As a result of a 1967 settlement negotiated with the SEC, the IOS foreign investment companies were required to execute transactions either through a foreign broker or through a U.S. broker with a foreign branch office. Arthur Lipper Corporation was organized with its principal office in New York City, became a member of the NYSE, other national securities exchanges and the NASD and opened branch offices in London and Geneva. An elaborate communications network was installed between the branch offices and New York.

The IOS foreign investment companies became customers of Arthur Lipper Corporation. They were able to execute efficiently transactions in the United States

securities markets through the communications network. This communications network was also used by the IOS group to issue and receive instructions through Arthur Lipper Corporation to numerous other brokerage firms executing transactions at IOS' direction.

In accordance with the customary securities industry practices at the time, the foreign investment companies issued written instructions ordering Arthur Lipper Corporation and the other brokers to share commissions on transactions both executed on the national securities exchanges and in the over-the-counter market. As is the custom for NYSE member firms executing agency transactions in the over-the-counter market, Arthur Lipper Corporation at all times charged only the NYSE mandated minimum commission rate.

Pursuant to the written instructions of the foreign investment companies Arthur Lipper Corporation shared over-the-counter commissions with Investors Planning Corporation ("IPC"), a broker which was an 80% owned subsidiary of IOS. IPC was registered with the SEC and was a member of the NASD. The record shows that other brokers which were members of the NYSE received the same instructions from the foreign investment companies as those received by Arthur Lipper Corporation and shared commissions on over-the-counter transactions with IPC.[4] Arthur

[4] The record demonstrates that the following brokers followed instructions of the IOS related funds and ,like Arthur Lipper Corporation, shared commissions with IPC on over-the-counter transactions: Ladenberg, Thalmann & Company; Glore, Forgan & Staats, Inc; Adams & Peck; Bear, Stearns; Emmanuel Deetjen & Co; Jessup & Lamont; Drexel, Harriman & Ripley; George Robinson & Co; Baker, Weeks & Co.; Hertz, Warner & Co; Hertzfeld & Stern; and White, Weld & Co. The NYSE was aware of the practice followed by its members of sharing over-the-counter commissions with NASD members, and did not disapprove of the practice. There is no evidence in the record that any firm, exchange or self-regulatory body considered the practice improper.

Lipper Corporation and the other brokers were permitted to share over-the-counter commissions with IPC because IPC and the firms executing the transactions were all members of the NASD. During the period in question approximately $2.6 million in commissions were shared between Arthur Lipper Corporation and IPC, with the latter firm receiving approximately $1.4 million.

The SEC charged that IOS breached its fiduciary duty to the foreign investment companies by causing those foreign investment companies to direct Arthur Lipper Corporation to share over-the-counter commissions with a subsidiary of IOS. In its opinion the SEC found that IOS and Petitioners should have negotiated a 50% reduction in the customary NYSE commission rate charged by Arthur Lipper Corporation. Failure to negotiate this 50% reduction was a "gross breach of fiduciary duty" by IOS which Petitioners aided and abetted. (App 41a) The SEC expelled Petitioners permanently from the securities industry. (App 72a)[5]

The Court of Appeals ignored the SEC's theory that Arthur Lipper Corporation and IOS were required to negotiate a 50% reduction in NYSE commission rates. Judge Friendly, writing for the Court of Appeals, rejected the SEC's conclusion that over-the-counter commission sharing was per se fraudulent. However, relying on precedents in several Second Circuit de-

[5] The Administrative Law Judge had suspended Arthur Lipper Corporation only from over-the-counter trading for twelve months and Mr. Lipper from the securities industry for the same period.

cisions which have superimposed the common law of fiduciaries upon the SEC's Rule 10b-5, Judge Friendly opined that IOS should have returned the shared commissions to the foreign investment companies or reduced the advisory fee IOS charged the foreign investment companies by the amount of brokerage commissions that IOS was able to recapture through its subsidiary, IPC. Since the SEC had proceeded under another theory, no evidence was introduced in the administrative proceeding to establish whether or not the shareholders benefited from the commission sharing with IPC.

In December 1976 the Court of Appeals reduced the permanent sanctions imposed by the SEC to twelve month suspensions of Petitioners from the securities business; the suspensions ran from the date of the SEC's order, October 24, 1975. (App 72a)

SUMMARY OF ARGUMENT

The SEC instituted these proceedings in September 1969; its decision over six years later concluded that Petitioners should have negotiated a 50% reduced commission.[6] The Court of Appeals disagreed and concluded that Petitioners made the proper commission charge but since IOS did not reduce its advisory fee, Petitioners aided and abetted IOS in its wrongdoing. On the other hand, if IOS had reduced its advisory fee, Petitioners conduct, *which was exactly the same*

[6] Three of the six years involved an unexplainable lapse between the date oral argument was held before the SEC Commissioners and the date on which the decision was entered. The length of time during which the SEC Commissioners had the matter under advisement suggests that the issues, which were wholly legal in nature, were not readily ascertainable, even for the most sophisticated legal minds knowledgeable and trained in securities law.

in either event, would have been laudable. It seems apparent that Petitioners should not be placed in peril contingent upon the actions of IOS, over which Petitioners had neither control nor influence. This is the issue which neither the SEC nor the court below faced.

The Court of Appeals sought to "soften the blow" by reducing the SEC's sanction and making the suspension retroactive. However, Petitioners are indelibly stained with a finding that they participated in a fraud—a finding which has an irrevocable effect on Petitioners' reputation in an industry where reputation is crucial.

REASONS FOR GRANTING THE WRIT

I. The Decision Below Is In Conflict With The Decisions Of This Court In *Santa Fe* v. *Green,* — U.S. — No. 75-1753, 97 S.Ct. 1293 (March 23, 1977), and *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976); It Also Conflicts With The Holding Of *Sanders* v. *John Nuveen & Co.,* — F.2d — No. 75-1260 (C.A. 7, April 22, 1977).

A. *Santa Fe* v. *Green*

The decision below failed to consider the express language in Section 10(b) of the Securities Exchange Act of 1934 ("Act") and, instead, relied on the Second Circuit's "gloss" coated on Rule 10b-5 over the years. Section 10(b) of the Act authorizes the SEC to adopt rules outlawing manipulative or deceptive practices. The Court of Appeals simply accepted the SEC's assumption that any breach of fiduciary duty constitutes fraudulent conduct in violation of Rule 10b-5. This Court, however, in the *Santa Fe* case held that conduct must be manipulative or deceptive to violate Rule 10b-5. This Court said (— U.S. —, slip op. at 10):

> The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Nor have we been cited to any evidence in the legislative history that would support a departure from the language of the statute. . . . Thus the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute.

The Petitioners' conduct which the Court of Appeals found fraudulent was Arthur Lipper Corporation's following written instructions from its customers to share over-the-counter commissions. But there was nothing unusual about such instructions. At that time institutional customers issued similar instructions to brokers executing their transactions in all markets. As long as the instructions provided for commission sharing with another bona fide member of the brokerage community, the executing broker was not acting inconsistent with the various rules of the NYSE and the NASD, the securities self-regulatory agencies. There was no rule of law which required executing brokers to determine whether investment managers and institutional customers were living up to whatever fiduciary responsibilities they may have assumed towards shareholders of the institutional customers, particularly one, as is the case here, which is unaffiliated with the institutional customer and its investment manager.

The gist of the breach of fiduciary duty is Judge Friendly's belief that IOS deceived the shareholders of the foreign investment companies. Thus, it is implicit in the decision of the court below that if IOS had made arrangements to disclose in the prospectuses

of the foreign investment companies that IOS was receiving compensation in addition to that received for its services in furnishing investment advisory services, no deception would have existed.[7] Although the prospectuses did not contain such disclosure, there is absolutely no evidence that Petitioners in any way joined in or "aided and abetted" the alleged deception. Even under United States fiduciary law, Arthur Lipper Corporation, as an unaffiliated broker acting as agent for an investment company in executing transactions in the securities markets, has no obligation to police its customers' activities to ascertain whether its customers and their fiduciaries have abided by their responsibilities.

It is vitally important to understand, as conceded by the court below, that the give-up instructions were not fraudulent per se. This finding is, of course, at odds with the decision of the SEC. However, the Court of Appeals was faced with an evidentiary record, conveniently ignored by the SEC, establishing that Arthur Lipper Corporation did precisely what was done by all other members of the NYSE. Accordingly, the Court of Appeals found unacceptable the SEC's theory that Arthur Lipper Corporation and IOS could have negotiated a 50% reduction in the commission rate. There simply was no evidence that such negotiation could or ever did occur in the securities industry. Since IOS' conduct was not fraudulent per se and since the only possible deception involved relationships between IOS, its foreign investment companies and their shareholders, Petitioners' conduct cannot be vio-

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[7] This is wholly apart from the question discussed, *infra*, whether the SEC may expand Rule 10b-5 to apply to fiduciary relationships outside the United States.

lative of Rule 10b-5—clearly Petitioners played no active part in any alleged "deception". To the extent that the court below snared Petitioners in this Rule 10b-5 web, the decision conflicts with this Court's holding in *Santa Fe*.

B. *Ernst & Ernst* v. *Hochfelder*

In the recent *Hochfelder* case this Court held that scienter *i.e.,* an intent to deceive, manipulate or defraud, was a necessary element in a violation of Section 10(b) and Rule 10b-5. Following a comprehensive review of the legislative and administrative history of the section and rule this Court stated (425 U.S. at 206) that "there is no indication that Congress intended anyone to be made liable for such [illicit] practices unless he acted other than in good faith". *Hochfelder* involved a suit for damages under Rule 10b-5 in which this Court refused to hold an accounting firm liable in the absence of evidence of a fraudulent intent or at least reckless conduct.

The court below indicated (App 15a) that it was assuming that the same element of scienter, which this Court found in *Hochfelder* was necessary to create liabilities for damages under Rule 10b-5, governs SEC administrative proceedings to revoke a broker's license.[8] The court below concluded, however, that in

[8] However, the validity of this assumption has been questioned by a recent decision of the SEC, *In Re Steadman*, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,243. In that case, the SEC indicated that the scienter requirement of *Hochfelder* was inapplicable to SEC administrative proceedings involving Rule 10b-5, SEAR No. 13695, p. 17. In *Hochfelder* this Court left open the question of the necessity of the scienter requirement under Rule 10b-5 in actions other than an action for damages, 425 U.S. 193, N. 12. As evidenced by the *Steadman* decision, whether the SEC is bound by *Hochfelder* in its administrative proceedings, involves an important, current question of federal law, present in this case, which should be resolved by this Court.

charging the full NYSE commission rates on over-the-counter transactions and in rebating half of the commissions to a subsidiary of IOS which retained the commissions paid to it, Petitioners' conduct constituted a "cunning device". (App 19a) This was so, Judge Friendly wrote, because these commission payments "should have been turned over to the funds directly or applied to reduce the advisory fee". (App 19a) No citation of authority accompanies these statements; for there is no rule of law, even United States fiduciary law, which necessarily required this result. No evidentiary record supports this finding. In fact, the IOS foreign investment companies experienced higher operating expenses than U.S. investment companies, although the fees charged were comparable. In any event, the executing broker's responsibility to his customers ended when the broker carried out the customer's instructions to share the commission with another broker. The apparent requirement by the Court of Appeals, that the executing broker second-guess his customer's instructions, is unprecedented.

Indeed, it is ironic that the Court of Appeals failed to discuss a proposed rule which the SEC had circulated for comment in early 1968.[9] The SEC's proposed Rule 10b-10 would have been adopted under Section 10(b) of the Securities Exchange Act and would have achieved precisely the result suggested by the court below, *i.e.,* an investment adviser which recaptures

[9] Proposed Rule 10b-10, Securities Exchange Act of 1934 Release No. 34-8239, 33 Fed. Reg. 2393 (1968).

commissions through give-up practices would have been required under proposed Rule 10b-10 to offset the amount of commissions recaptured against the advisory fee charged. Nothing in the release which accompanied the proposed rule, however, even suggests that the executing broker over whom the SEC has broad regulatory power, owed a responsibility to make certain that the recipient of the shared commission did, in fact, return it indirectly to the customer. Moreover, Rule 10b-10 was not adopted. The NYSE banned all forms of give-up practices in December 1968. Obviously, the SEC did not then believe that Rule 10b-5 banned give-up practices that did not result in the investment advisory fee offset; otherwise, the SEC would not have felt the need to propose a rule such as Rule 10b-10.

In a real sense, the court below has promulgated the long-departed proposed Rule 10b-10 under an expansive "interpretation" of Rule 10b-5 and applied it *ex post facto* to Petitioners.

In addition, in considering this Court's decision in *Hochfelder,* the Court of Appeals concluded that advice of counsel was not relevant in determining whether a violation of Rule 10b-5 occurred; advice of counsel was only relevant to the question of penalty. We disagree and contend that such a result runs counter to *Hochfelder.* Where a broker seeks out competent counsel to advise it concerning an extremely intricate area of the securities law, and such counsel determines that the broker may follow the prevailing industry practice until such time as the SEC makes it unlawful by rule, such conduct is highly relevant to whether the broker intended to engage in fraudulent conduct. In fact, the Court of Appeals ultimately

agreed that the advice rendered by counsel was correct, at least to the extent that the SEC was wrong in saying that over-the-counter give-ups were fraudulent per se. Even though the SEC did not reach the question of counsel's independence, the Court of Appeals rejected Petitioners' reliance on advice of counsel on the grounds that this same counsel had represented IOS in other matters. The court never explains, however, why this element should redound to the detriment of Petitioners or why their reliance on the advice is evidence of a fraudulent intent on their part.

A review of the evidentiary record establishes that Petitioners acted in good faith on the advice of well-qualified [10] counsel and in accordance with then existing securities industry practices. The record shows, therefore, that Petitioners did not intend to deceive, manipulate or defraud and the decision below conflicts with *Hochfelder* in this regard.

C. *Sanders* v. *John Nuveen & Co.*

John Nuveen involved a Rule 10b-5 class action suit by purchasers of short term commercial paper against a brokerage firm acting as underwriter of the commercial paper. This Court granted the broker's petition for certiorari, vacated the order of the Court of Appeals affirming judgment against the broker and remanded the case in the light of *Hochfelder,* 425 U.S. 185 (1976). On remand, the Court of Appeals for the Seventh Circuit found "the record is barren of any showing of actual intent to deceive, manipulate or defraud" (slip op. at 3); therefore the Court of Appeals

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[10] Petitioners' counsel had served as a director of the SEC's division charged with the regulation of investment companies, as well as serving as the SEC's General Counsel.

held that the judgment could not rest on a violation of Rule 10b-5. The trial court had found that the broker's investigation of the issuer was deficient and that an appropriate investigation would have revealed the issuer's fraud. The Court of Appeals held that, nevertheless, the broker's conduct was not reckless; at least to the extent such conduct rose to the level of "a lesser form of intent" (slip op. at 4) and hence the equivalent of scienter required for a Rule 10b-5 violation.

The decision of the Court of Appeals for the Second Circuit conflicts with this holding. The standard applied by the court below was that Petitioners knew what they were doing *i.e.*, they knew they were sharing commissions with a broker who performed no services in return for those commissions. But the industry practice at that time was exactly that—executing brokers always followed their customer's instructions to share commissions with other brokers. No one ever suggested that it was the executing broker's duty to determine whether the broker receiving the shared commissions could lawfully receive them. The SEC never suggested that an unaffiliated executing broker had such a duty. Because of the NYSE's fixed commission rate structure (which Petitioners deplored, but to which they were irrevocably bound), it certainly was not negligent or reckless on Petitioners part to follow their customers' instructions.

II. The Decision Below Expands Rule 10b-5 Fiduciary Concepts To Persons Operating Outside The United States.

The Court of Appeals found that Petitioners' jurisdictional arguments ignored the fact "that the fraud charged by the SEC was perpetrated in the United States by payments from one registered broker-dealer

(Lipper Corp.) to another (IPC) in connection with the purchase and sale of securities in the United States over-the-counter market". (App 13a) Petitioners did not ignore this; the Court of Appeals simply engaged in the expediency of misstating a litigant's argument. Keeping in mind that Section 10(b) of the Act requires a deception as a necessary element in a violation,[11] it is quite clear that the only persons who could possibly have been deceived were the shareholders of the foreign investment companies. The give-up instructions, it is recalled, were issued by authorized representatives of the foreign investment companies. Therefore, Arthur Lipper Corporation's customers were not deceived.

Petitioners have been unable to discover the origin of the rule of law relied on by the Court of Appeals which imposes an obligation on the part of the manager of foreign investment companies to tell shareholders that additional compensation was being paid to it through shared brokerage commissions.

First, one would assume that shareholders in a Canadian investment company and a Luxembourg trust would not be governed by the common law fiduciary standards engrafted upon Rule 10b-5 by the SEC, with the aid and assistance of the Second Circuit. We certainly believe that a citizen of Hong Kong who bought shares in the Luxembourg trust would be surprised to discover that the United States federal securities laws were applicable to his purchase of interests in the trust. Second, and most important, Petitioners' jurisdictional argument, which the Court of Appeals misstated and hence avoided, is as follows: any deception

[11] See *Santa Fe, supra*.

in this factual context had to be related to the purchase of the securities issued by the foreign investment companies. In other words, the real charge, which neither the SEC nor the court below articulated, is that the prospectuses of the foreign investment companies did not disclose tc prospective investors residing outside the United States (and ultimately to the shareholders of the investment companies) that IOS was receiving compensation in addition to the compensation received in its capacity as investment adviser.

Once this concept is accepted, it becomes readily clear that a necessary element is missing for a violation of Section 10(b) and Rule 10b-5. In connection with the purchase or sale of the securities of the foreign investment companies there was no "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange" as is required by the express language of the Section and Rule.

The U.S. jurisdictional means were not used in connection with the sale of the shares of the foreign investment companies. The fact that the U.S. jurisdictional means were used in the purchase and sale of the portfolio securities of the foreign investment companies is immaterial since no "deception" occurred with respect to the purchase and sale of the portfolio securities. The alleged "deception" could only have occurred outside the United States in the offer and sale of the shares of the foreign investment companies; as the record of this case makes clear, a necessary element for a Rule 10b-5 violation is missing with respect to the shares issued by the foreign investment companies to their shareholders, namely use of U.S. jurisdictional means.

Both the SEC and the court below refused to address Petitioners' contention; and in avoiding it, were able to expand Rule 10b-5 to foreign jurisdictions.

Moreover, as the evidentiary record shows, it was the acceptable and customary practice in Europe for an investment manager or banker, such as IOS, to charge an additional commission for the placing of orders with United States brokerage firms. Hence, consistent with this established practice, IOS would have been justified in charging a commission in addition to the compensation it received as investment adviser. While this institutional practice may not be either customary or even permitted in the United States under national securities exchange regulations or the federal securities laws, such evidence demonstrates that IOS may not have engaged in a "deception" of its shareholders.

III. Petitioners Were Denied Due Process By The SEC

Although it rejected the SEC's "fraud per se" rule, the court below compounded the SEC's denial of due process: it too ignored the evidentiary record. Because the SEC was convinced that commission sharing in the over-the-counter markets was inherently fraudulent in violation of Rule 10b-5, the SEC did not require its staff to develop an administrative evidentiary record which included any evidence that Petitioners had an intent to defraud. Indeed, the evidence clearly established that Petitioners did not intend to deceive anyone. Proof of scienter, a prerequisite for a violation of Rule 10b-5, (See *Sanders* v. *John Nuveen & Co. supra,* slip op. at 9) is absent from the record of this case.

Petitioners introduced convincing evidence, completely ignored by the SEC, that Arthur Lipper Cor-

poration did precisely what was done by all other members of the NYSE, that is:

(1) members charged the NYSE commission rates in executing agency transactions in the over-the-counter market;

(2) this practice was in fact a requirement of the NYSE in order to prevent commission rate-cutting in the over-the-counter market for the same customer with whom the member was doing NYSE business;

(3) members readily shared commissions at a customer's direction both on NYSE and over-the-counter transactions;

(4) the sharing of commissions on over-the-counter transactions was permissible with other members of the NASD and

(5) the foreign investment companies received best execution of securities transactions through Arthur Lipper Corporation.

The SEC had hoped that statements it had made in various studies and in a SEC staff letter would be acceptable proof of fraud. The statements announced simply that give-ups in the over-the-counter market were fraudulent because the commission rates in that market were negotiable. Although the court below rejected such "proof", Judge Friendly simply formulated a new theory: IOS should have returned the commissions to the foreign investment companies. Since this was *not* the SEC's theory at the administrative trial, no evidence supports Judge Friendly's speculation.

A fatal blow to Judge Friendly's theory would be evidence that during this period the NYSE would have sought to revoke Petitioners' membership in the NYSE for participating in a rebate arrangement to the customers of the brokerage firm—the foreign investment companies. While neither Judge Friendly nor the SEC were overly concerned with the NYSE rules and regulations, Petitioners were in a different boat. However convoluted the NYSE interpretations may seem in hindsight (and Petitioners agree the whole commission rate structure of the NYSE was an odious relic of bygone days), nevertheless it is clear that: (1) Arthur Lipper III was a businessman dependent for his livelihood on adhering to those rules and interpretations of the NYSE which governed his brokerage arrangements and (2) IOS' return of the commission dollars to the foreign investment companies would have been an unquestioned rebate.

Secondly, IOS did perform research and sales services for the foreign investment companies. The court below specifically stated that shared commissions could be used to pay for these services. (App 10a)

Thirdly, Petitioners sought out the advice of an experienced and competent securities counsel—hardly the course of action of one bent on participating in a "cunning device".

Fourthly, the commission sharing payments were recorded methodically and openly on the books and records of Arthur Lipper Corporation—books and records which are readily available for inspection at anytime without the necessity for a subpoena by the SEC, the NYSE and the NASD. One would suspect that a knowing participant in a "cunning device" would be less circumspect.

It has shocked the SEC to learn that "scienter" is to be a requirement of its own creation—Rule 10b-5. To require the SEC to actually introduce evidence that someone trapped in its administrative web intended to deceive the other party to the transaction will undoubtedly precipitate the predictable anguished cries of budgetary shortcomings and a lessening of investor protections. The irony here, of course, is the inordinate amount of SEC time and money spent on protecting shareholders of foreign lands. In any event, Petitioners are U.S. citizens and, as such, are entitled to the constitutional protections of due process contained within Amendment V of the U.S. Constitution. The SEC has simply not met its burden of proof by introducing evidence of deception and, by its failure, has denied Petitioners due process of law.

CONCLUSION

A businessman who follows in good faith the advice of well-qualified counsel and adheres to industry practice should not be accused of aiding and abetting violations of Rule 10b-5. It took the SEC and the court below seven years to define IOS' wrongdoing and they disagreed. Petitioners' involvement was completely in accordance with then existing business practices.

The conduct attacked by the SEC was prevalent in the securities industry for a long period of time. Then, early in 1968, the SEC circulated for comment proposed Rule 10b-10 to require investment managers to return give-ups to their customers. The proposed rule was withdrawn when the NYSE banned all forms of give-ups. This was done because the NYSE did not want to see the development of a practice of investment managers offsetting their advisory fees by the amount of shared commission dollars; such arrangements would have been authorized rebates, an unacceptable gap in the NYSE fixed minimum commission rate structure. The banning of give-ups was seen by the NYSE as the election of the lesser of two evils.

Although give-ups were banned in December 1968, the holding of the court below has far-reaching consequences for the brokerage community; the court below has placed undue burdens on relationships between brokers and their unaffiliated institutional customers. Despite the fact that the court's decision, in effect, permits Petitioners to re-enter the securities business, it did not erase the stain of a Rule 10b-5 violation and the resulting irreparable harm to Petitioners' reputations in an industry where one's business reputation is all important. In addition, the debris from the SEC's action spreads far—even to the extent that the Internal Revenue Service has asserted that the commissions which Arthur Lipper Corporation shared with IPC are not deductible because the payments were illegal rebates. This visits a possible $761,195 tax claim upon Petitioners. This IRS position has immediate and far-reaching impact on the numerous highly-publicized cases the SEC is currently conducting against U.S. corporations and their officers who have engaged in allegedly "illegal" commercial and political payments, both domestic and foreign. Accordingly, Petitioners request that the writ of certiorari issue so that Petitioners may have an opportunity to be vindicated and

the unjustified expansion of SEC Rule 10b-5 doctrine may be contained.

Respectfully submitted,

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August 1977

APPENDIX

APPENDIX

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

ARTHUR LIPPER CORPORATION and Arthur Lipper III,
Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

No. 165, Docket 76-4067

Argued Oct. 21, 1976

Decided Dec. 10, 1976

Before FRIENDLY, HAYS and MULLIGAN, Circuit Judges.

FRIENDLY, Circuit Judge:

This petition to review a disciplinary order of the Securities and Exchange Commission (SEC), Securities Exchange Act Release No. 11773 (Oct. 24, 1975), is the latest chapter in the extensive litigation resulting from the financial debacle of IOS, Ltd., S.A. (IOS) and the off-shore funds for which it was investment adviser and distributor. *See Bersch* v. *Drexel Firestone, Inc.*, 519 F.2d 974 (2 Cir.), *cert. denied*, 423 U.S. 1018, 96 S.Ct. 453, 46 L.Ed.2d 389 (1975); *IIT* v. *Vencap, Ltd.*, 519 F.2d 1001 (2 Cir. 1975). We deal here with an order under § 15 of the Securities and Exchange Act, 15 U.S.C. § 78*o*, which revoked the broker-dealer registration of Arthur Lipper Corporation (Lipper Corp.) and barred Arthur Lipper III (Lipper), its principal owner, from association with any broker or dealer. The order, dated October 24, 1975, was predicated on violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the Commission's Rule 10b-5, 17 C.F.R. 240.10b-5, during 1967 and 1968. We confirm the decision that a violation occurred but modify the penalty to suspension for a period of 12 months from the effective date of the SEC's order.

I. The Facts and Proceedings Before the SEC

The complaint concerns transactions whereby at the direction of Edward M. Cowett, executive vice-president and director of IOS, Lipper Corp. turned over to IOS's 80%-owned subsidiary Investors Planning Corporation (IPC), a registered broker-dealer and a member of the National Association of Securities Dealers, Inc. (NASD), a total of $1,450,000, out of the commissions earned by Lipper Corp. on over-the-counter (OTC) transactions for the account of three off-shore funds for which IOS or one of its affiliates was investment adviser. These were Fund of Funds, Ltd. (FOF), a Canadian corporation which invested chiefly in United States mutual funds and also was the sole owner of another investment company, FOF Proprietary Fund, Ltd. (FOF Prop.); International Investment Trust (IIT), organized under the laws of Luxemburg, which invested in companies throughout the world; and Regent Fund Ltd. (Regent), a Canadian investment company with investments in both Canada and the United States. IIT and Regent had no American shareholders; FOF had some 3,000 of a total of over 100,000, although the shares so owned had been acquired without any registration of FOF shares under § 6 of the Securities Act of 1933, 15 U.S.C. § 77f.

IOS had itself been a registered broker-dealer with its principal place of business in Geneva, Switzerland. In 1965, it acquired IPC, based in New York, apparently with a view to building up IPC, which had been operating at a loss, as a vehicle of IOS's American securities business. This plan was shattered and a revamping of IOS' method of doing business was compelled by a SEC order of May 23, 1967, accepting an offer of settlement of a proceeding it had brought on February 3, 1966 against IOS, Bernard Cornfeld (its organizer), Cowett and others. This order provided, so far as here pertinent, that IOS would withdraw its broker-dealer registration; that IOS, FOF, IIT and any investment company affiliated with any of them

should conduct no activity subject to the SEC's jurisdiction except as provided in the order; and, save for qualifications not here material, that within 16 months IOS should dispose of its entire interest in IPC. The effect of the order was to require IOS to devise some method whereby orders for transactions on United States stock exchanges or in the OTC market would have to be placed with exchange or NASD members having offices abroad [1] or with foreign broker-dealers who in turn would refer the orders to American broker-dealers able to execute them. The order also furnished IOS an incentive to build up the value of its equity in IPC in order to increase the price it could obtain upon the required sale.

Anticipating the settlement, Cowett approached Lipper, a partner in the New York Stock Exchange (NYSE) firm of Zuckerman, Smith & Co., to ascertain whether the firm would be interested in opening branch offices in Geneva and London, together with the extensive communications network that would be needed for the purpose of serving as coordinating agent for the flow of IOS brokerage transactions. The other partners in Zuckerman, Smith & Co. declined the proposal although they were willing to have the firm act as clearing agent if Lipper decided to withdraw and form his own company, which would become a registered broker-dealer and member of NYSE and NASD for the purpose desired by IOS. Lipper indicated his interest to Cowett, and proceeded to make the necessary arrangements. His compensation was to be in commissions earned on IOS generated transactions both on and off the exchanges, as to which his company was to be in a favored position.

The Constitution of the New York Stock Exchange required Lipper Corp. to charge the three off-shore funds the fixed commissions then in effect on transactions exe-

[1] Petitioners assert and the SEC does not dispute that all such offices were operated by members of the New York Stock Exchange.

cuted on that exchange and forbade any rebates to them. Until December 5, 1968, NYSE allowed customer-directed give-ups on NYSE transactions to other NYSE members. The record is silent how far IOS directed Lipper Corp. to make such give-ups; in any event the SEC makes no complaint against Lipper Corp. with respect to NYSE transactions. The conduct of which it does complain relates to OTC transactions for the three off-shore funds. As to these also Lipper Corp. charged the commissions provided by the NYSE minimum rate schedule. However, as Lipper anticipated, directions were received from Cowett to give up 50% of these commissions to IPC.[2] Pursuant to these instructions Lipper Corp., during the period from July 10, 1967, to August 5, 1968 remitted to IPC approximately $1,275,000, about 50% of the commissions paid it by FOF Prop., ITT and Regent Fund on OTC transactions.[3] In addition, because cash was required for IPC before September 30, 1968, in order to meet warranties in a subsequently aborted contract for the sale of IPC, Cowett, as president of FOF Prop., by letter dated August 14, 1968, requested that, over and above the "regular" 50% give-

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[2] By letter dated June 29, 1967, Cowett, as president of FOF Prop., directed Lipper Corp. to give up to IPC "the maximum give-up (50%)" on commissions earned on OTC transactions for the account of FOF Prop. On July 11, 1967, as a representative of IIT Management Co., (S.A.), an IOS affiliate, Cowett gave similar written instructions with respect to OTC transactions for the account of IIT. By letter dated March 15, 1968, Cowett, as vice president of Canadian Fund Management Company Limited, also an IOS affiliate, confirmed an earlier request for similar give-ups on OTC transactions effected on behalf of Regent Fund, Ltd.

[3] The details were:

	Gross Commissions	*Give-Ups*
FOF Prop.	$1,974,064	$ 950,821
IIT	636,423	312,175
Regent Fund	28,670	12,521
Total:	$2,639,157	$1,275,517

up, Lipper Corp. should make additional give-ups to IPC of $175,000 on or before August 30, 1968, and another $175,000 on or before September 30, 1968. Lipper demurred to the size of the request, telling Cowett that no more than an extra $175,000 should be paid. On August 28, Lipper Corp. sent this extra sum, bringing the total give-ups to IPC to some $1,450,000. The Commission found that neither IOS nor IPC rendered services to the funds in return for these give-ups.

No disclosure of the Lipper Corp.-IPC give-ups was made to the shareholders of FOF (the sole owner of FOF Prop.), of IIT or of Regent Fund. No such disclosure was made directly to the directors of IIT or of Regent Fund. Apparently the most nearly complete disclosure occurred at a meeting of the board of directors of FOF held in Acapulco, Mexico, in April 1968, at which Lipper was present, when Allan F. Conwill, Esq., a director of FOF and counsel for it, IOS, Lipper Corp. and Lipper, informed the FOF directors of the arrangements outlined above; he also advised that Lipper Corp. was in effect required to charge the minimum NYSE commissions for OTC transactions; that there was no legal way for Lipper Corp. to refund any part of such commissions to FOF; that the SEC staff took the position that any give-up on OTC business was a fraud *per se* since there was no fixed rate commission structure on OTC transactions and willingness to give-up a part of the commission showed that the broker would have been willing to take less; but that he considered this position to be unfounded in law. There is no evidence that anyone suggested exploration by outside counsel of the validity of Mr. Conwill's view that Lipper Corp. had to charge the minimum NYSE commission on OTC transactions or that no way could be found whereby the shareholders of FOF would benefit from give-ups to IPC.

Upon these facts and others that will be stated in our discussion, Chief Hearing Examiner, now Administrative Law Judge (ALJ), Blair found on June 11, 1971 that Lip-

per Corp. and Lipper had willfully violated and willfully aided and abetted violations of § 10(b) of the 1934 Act and Rule 10b-5. Overruling both the assertion of the petitioners that no sanctions should be imposed and the staff's contention that the registration of Lipper Corp. should be cancelled and Lipper should be permanently barred from the securities business, he determined that a suspension of one year from the effective date of the order would be the proper sanction as to both. Lipper and Lipper Corp. and the staff filed petitions for review by the Commission, which heard argument on August 28, 1972. By a decision filed on October 24, 1975, the SEC sustained the ALJ's conclusion with respect to violations but directed the drastic remedies of cancellation of Lipper Corp.'s registration and the permanent barring of Lipper from the securities business urged by the staff. Petitioners sought rehearing on the sole basis that three of the four Commissioners who participated in the decision had not been members at the time of argument. The petition for rehearing was denied on January 6, 1976. Securities Exchange Act Release No. 11980. This petition for review followed.

II. Liability

Sections 15(a)(4) and (6) of the Securities Exchange Act authorize the SEC to suspend for a period not exceeding twelve months or to revoke the registration of any broker or dealer or to bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer on various grounds. One is willful violation of any provision of the Act or any rule or regulation thereunder; another is willful aiding, abetting, counseling, commanding, inducing or procuring any such violation. The familiar Rule 10b-5 reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

There is some initial surprise in seeing Rule 10b-5 invoked where the fraud relates not, as in the usual case, to a particular securities transaction but to a course of dealing in securities regardless of their identity. However, the language of the Rule is broad enough to include the latter type of case and petitioners do not urge that the Rule has no application to a course of dealing where the fraud concerns the overall relation of broker and customer rather than the overvaluation or undervaluation of a security sold or purchased. We see nothing in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), that would militate against application of the Rule in a situation like that here before us, though "the terms 'purchase' and 'sale' are relevant . . . to the question of statutory coverage" even in other than private actions, *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 467 n.9, 89 S.Ct. 564, 572, 21 L.Ed.2d 668 (1969).

Portions of the Commission's decision seem to take the view, which had been the staff's principal reliance at the hearing and was also stressed in the oral argument of counsel before us, that any give-up of a commission on an OTC transaction is *per se* a "device, scheme, or artifice to defraud." In support of this the Commission points particularly to two passages in its report of December 2, 1966,

on the Public Policy Implications of Investment Company Growth (hereafter PPI), H.R.Rep.No.2337, 89th Cong., 2d Sess. These are:

> A directed give-up of a portion of the commission charged for handling a transaction for a fund in the over-the-counter market would be a patent waste of investment company assets. Since the over-the-counter market in both listed and unlisted securities is a negotiated market, which is not governed by fixed prices or minimum commission rate schedules, any willingness of the executing broker or dealer to allow his customer to direct a give-up of a portion of his commission or markup to dealers in fund shares in and of itself shows that a lower price or commission could have been negotiated.

and

> In the over-the-counter markets, where brokerage costs are subject to negotiation, give-ups of commissions to brokers who perform no necessary function in connection with a transaction have long been recognized as improper and illegal. Give-up practices have been tolerated in the exchange markets only because brokerage costs are fixed by the exchange minimum commission rate schedules.

Id. at 178, 185 (footnote omitted).[4]

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[4] The Commission relies also on a July 18, 1966 letter from Irving M. Pollack, then Director of the Division of Trading and Markets, to the presidents of various stock exchanges and of the NASD. One sentence in the three and one-half pages of single spaced text of the letter, which expressed concern about the give-up problem generally, said:

> In this connection, we consider it significant that "give-ups" in the over-the-counter market have long been recognized to be improper and illegal.

Apart from the fact that the letter came from a staff member (albeit a high one) rather than from the Commission, we can hardly regard such an incidental statement, for which no explanation was given, as putting the entire industry on sufficient notice of the Commission's views.

Insofar as the Commission would attribute legal force to these statements in PPI, we must disagree. While the Report was transmitted to Congress by the Chairman of the Commission pursuant to § 14(b) of the Investment Company Act, it constituted information for the legislature, not a rule having the force of law for the industry, as would a regulation adopted pursuant to 5 U.S.C. § 553. Indeed, we doubt whether these two passages from a 346 page report would qualify even as an "interpretative rule" or a "general statement of policy." In saying this we are quite aware of the importance attached to other portions of PPI in *Moses* v. *Burgin*, 445 F.2d 369, 383-84 (1 Cir.), *cert. denied*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971), and in *Fogel* v. *Chestnutt*, 533 F.2d 731, 734-37, 749 (2 Cir. 1975), *cert. denied*, —— U.S. ——, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976). However, those cases cited PPI as placing the mutual fund industry on notice that the SEC believed there were opportunities for advantaging stockholders that ought to be explored and explained to the disinterested directors, not as having independent legal force. So here we regard the quoted statements from PPI as doing no more than warning the industry what position the Commission would be likely to take with respect to customer-directed give-ups in the OTC market.

We are not persuaded that any such all encompassing across-the-board *per se* principle as stated in PPI would be sustainable in the absence of a Commission rule. It is true that the source of the practice whereby the managers of investment companies directed executing brokers

to give up a part of their commissions to other brokers who furnished services in selling investment company shares and in providing research lay in the inordinate profits a few executing brokers would receive under the fixed commission rate structure prevailing on the exchanges. *See Fogel* v. *Chestnutt, supra,* 533 F.2d at 735-36. We are not certain, however, that even after PPI, if the manager of an investment company determined that the interests of the company would be served by paying fixed commission rates on OTC business, with customer-directed give-ups to brokers who had furnished sales or research service, and disinterested directors, on full disclosure, had joined with others in a good faith determination that this was in the fund's best interest, this would have violated Rule 10b-5. At least we would find it difficult to reach such a conclusion on this record, which contains no evidence that commissions on OTC agency business were in fact the subject of negotiation in 1967 or 1968; rather, as the Commission seemingly concedes in its opinion, a purchaser or seller unwilling to pay the fixed commissions generally charged on OTC business, because of the size of the transaction or for other reasons, would deal with a market-maker as a principal—a course which the 1967 settlement precluded IOS from following unless an American firm with an office outside the United States happened to be a market-maker in the particular issue in which IOS was interested.

However, we find it unnecessary to decide whether the extreme position thus far discussed is sustainable. The Commission based its decision primarily on the ground that IOS and its affiliates committed a fraud on the funds by diverting to themselves, through IPC, rebates which belonged to the funds while IPC was doing nothing in return, and that Lipper and his company willfully aided and abetted this. The proposition that it is a fraud on the fund for a manager simply to pocket give-ups which

he has diverted to himself is almost too clear for argument. While there has been controversy, illustrated by the *Moses* and *Fogel* decisions, how far an investment adviser was bound to secure give-ups when these were attainable, there has been and could be no question that if these were obtained, they must be applied for the benefit of the fund, either by direct payment or as a reduction in the advisory fees. See statement of then General Counsel Loomis, Securities Exchange Act Release No. 8746 (Nov. 10, 1969); *Provident Management Corp.,* 44 SEC 442, 447 (1970). We recognize that both statements came after cessation of the conduct here complained of, but the proposition needed no elucidation. *See also Moses* v. *Burgin, supra,* 445 F.2d at 376 n.11. It is no answer for petitioners to contend that they were in no position to police IOS' exercise of its fiduciary responsibilities; they still were under no obligation to engage in conduct aiding IOS' fraud on the funds.

Starting from this position, we shall consider petitioners' various attacks on the Commission's conclusions.

(1) Petitioners say that, as a practical matter, they were compelled to apply the NYSE minimum rate commission schedule on OTC transactions. Conceding that Article XV of the NYSE Constitution applied and legally could apply only to transactions on that exchange, they contend that NYSE looked with suspicion on the charging of lower rates on OTC transactions since such rates, at least if below cost, might operate in practical effect as a rebate of a portion of the commissions charged the same customer on NYSE business. They point to evidence that in fact NYSE would require a member that charged less than NYSE minimum commissions on OTC business to provide cost justification and contend that, as a new member operating a complex and costly trans-Atlantic communications network, it could not have satisfied NYSE

that lower commissions on IOS generated OTC transactions were cost justified.

We need not debate the solidity of the factual basis for the argument. Whatever force petitioners' contention might or might not have if Lipper Corp. had retained the full commissions on OTC business and the complaint was that this amounted to a gouging of the funds, this was not what occurred. In fact Lipper Corp. did just what it claims NYSE prevented it from doing, namely, conduct OTC business at less than NYSE commission rates. Give-ups to the manager of an investment company on OTC transactions infringed the NYSE policy that members should not compete for business on a price basis as much —or as little—as the charging of lower commissions or give-ups to the investment company itself would have done. As the Commission said:

> The Lipper respondents claim to have been in fear of disciplinary action by the New York Stock Exchange. But they have never explained why this fear did not restrain them from giving up to IPC. If the New York Stock Exchange's rules had been applicable to these transactions, they would have prohibited commission-splitting with IPC as well as with the funds that paid those commissions.

Putting the matter in another way, petitioners' conduct either violated the spirit of the NYSE Constitution or it did not. If it did, they can derive no comfort from the argument that their acts were compelled by the NYSE Constitution; if it did not, they likewise gain no protection.

In any event, no NYSE practice could immunize conduct assisting investment company managers effectively to pocket give-ups when the funds receive nothing in return.

(2) Petitioners argue that even though their conduct might have violated Rule 10b-5 if the three funds had been registered investment companies, a different conclusion is compelled because here the payment of give-ups to the manager was at the expense of off-shore funds, only one of which had American shareholders. The argument ignores that the fraud charged by the SEC was perpetrated in the United States by payments from one registered broker-dealer (Lipper Corp.) to another (IPC) in connection with the purchase and sale of securities in the United States over-the-counter market. We said in *IIT* v. *Vencap, Ltd., supra,* 519 F.2d 1017:

> We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners.

Petitioners thus derive no support from so much of the decision in *Bersch* v. *Drexel Firestone, Inc., supra,* 519 F.2d at 992, as held that merely preparatory activity or non-feasance in the United States was not sufficient to trigger application of the securities laws in a class action for damages in the absence of effect on Americans. Also, in light of its language and our previous decisions, notably *Schoenbaum* v. *Firstbrook,* 405 F.2d 200, 207-08 (2 Cir. 1968), *modified in other respects,* 405 F.2d 215 (*en banc*), *cert. denied,* 395 U.S. 906, 89 S.Ct. 1747, 23 L.Ed. 2d 219 (1969), no discussion is needed to demonstrate the inapplicability of § 30(b) of the Securities Exchange Act, 15 U.S.C. § 78dd(b), which exempts "any person insofar as he transacts a business in securities without the jurisdiction of the United States." Petitioners argue that characterizing the transaction as a fraud on the funds may displace otherwise applicable foreign law, since certain countries in which IOS and its affiliates operate would allow the manager of an investment company to receive

a commission for placing an order, in addition to the commission payable to the broker executing it. We do not think the result should differ on this account. Presumably the receipt of such commissions would have had to be reported by IOS and would thus have been known to existing shareholders of the funds and to persons solicited to buy their shares. Here IOS, through IPC, secretly pocketed the money. Moreover, we see no reason why the United States may not prescribe a rule for conduct within its borders even if another country having an interest might be less rigorous. *See Bersch* v. *Drexel Firestone, Inc., supra,* 519 F.2d at 985; Restatement of the Foreign Relations Law of the United States § 17 (1965).

(3) Little need be said in regard to petitioners' contention that the arrangements for the payment of rebates to IPC were adequately disclosed. Admittedly no disclosure was made directly to the boards of directors of IIT and Regent; the disclosure to the board of FOF was only that the arrangements were proper, with no attempt by independent directors to check this. Petitioners contend they could not compel disclosure; perhaps not, but here again they were under no obligation to engage in conduct that would be fraudulent without it. Moreover, it is not within the competence of a board of directors of an investment company to sanction the perpetration of a fraud by the manager. *Cf. Schoenbaum* v. *Firstbrook, supra,* 405 F.2d at 219-20; *Drachman* v. *Harvey,* 453 F.2d 722, 736-38 (2 Cir. 1972) (*en banc*). Indeed, it would seem that only a unanimous shareholder vote could ratify a fraud of this type even if approved by directors. See Ballantine on Corporations § 71, at 177 (rev. ed. 1946); Cary, Cases and Materials on Corporations 591-92 (1969); Lattin, Jennings & Buxbaum, Corporations 821 (1968 ed.); *Kennan* v. *Eshelman,* 23 Del.Ch. 234, 2 A.2d 904 (Sup.Ct.1938); *Continental Securities Co.* v. *Belmont,* 206 N.Y. 7, 99 N.E. 138 (1912). An arrangement

like that here at issue, which was a bald diversion to the manager of sums belonging to the investment company, is quite different from the situation in *Moses* v. *Burgin* and *Fogel* v. *Chestnutt,* where there were some arguable reasons against seeking recapture so that a negative decision by the board of directors, after full disclosure to the independent directors and approval by them and their colleagues, might protect an adviser from liability, under the business judgment rule. *See Fogel* v. *Chestnutt, supra,* 533 F.2d at 750.

(4) We find it convenient to treat together petitioners arguments on the scores of scienter, willfulness and reliance on the advice of counsel.

It would seem at first blush that since the relevant provisions of § 15 of the Securities Exchange Act require a showing of willful violation or willful aiding and abetting, little would have been added by the recent holding in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), that "scienter" is a necessary element to establish liability in an action for damages under Rule 10b-5. However, "the Commission has consistently held under § 15(b) that the term ['willfully" in § 15] does not require proof of evil motive, or intent to violate the law, or knowledge that the law was being violated. . . . All that is required is proof that the broker-dealer acted intentionally in the sense that he was aware of what he was doing." 2 Loss, Securities Regulation 1309 (1961). This view has been accorded judicial acceptance. As this court said in *Tager* v. *SEC,* 344 F.2d 5, 8 (2 Cir. 1965):

> It has been uniformly held that "willfully" in this context means intentionally committing the act which constitutes the violation. There is no requirement that

the actor also be aware that he is violating one of the Rules or Acts.[5]

Petitioners are thus right in contending that it is important to determine what standard of culpability *Hochfelder* imposes for a violation of Rule 10b-5 such as that here alleged, and specifically what the proper standard is in a disciplinary proceeding.

The *Hochfelder* plaintiffs sought to hold Ernst & Ernst, an international accounting firm, liable as an aider or abettor of one Leston B. Nay, president of First Securities Company of Chicago, a small broker. Nay had induced the plaintiffs to invest in allegedly high-paying "escrow accounts" which he immediately converted to his own use. The accounts did not appear in First Securities' books and records, payment having been made by personal checks payable to Nay or to a designated bank for his account. In urging that Ernst & Ernst was liable as an aider and abettor, plaintiffs "specifically disclaimed the existence of fraud or intentional misconduct," 425 U.S. at 190, 96 S.Ct. at 1380. The claim was that Nay had imposed a "mail rule" that no mail addressed to him or to First Securities to his attention could be opened by anyone other than Nay, even if it arrived in his absence; that if Ernst & Ernst had conducted a proper audit, they would have discovered the existence of this rule; that Ernst & Ernst should then have disclosed the rule, in reports to the SEC, as an irregular procedure that prevented an effective audit; and that this would have led the SEC to make an investigation of Nay that would have revealed his fraudulent scheme. The Supreme Court held that a mere claim of negligence did not suffice

[5] The court cited, in addition to the Loss treatise, *Gilligan, Will & Co.* v. *SEC*, 267 F.2d 461, 468 (2 Cir.), *cert. denied*, 361 U.S. 896, 80 S.Ct. 200, 4 L.Ed.2d 152 (1959), and *Hughes* v. *SEC*, 85 U.S. App. D.C. 56, 174 F.2d 969, 977 (1949).

to support an action for damages under Rule 10b-5 but that "scienter" must be alleged and proved.[6] Since plaintiffs had claimed nothing more than negligence, the Court had no occasion to refine its definition of *scienter* beyond saying that the term "refers to a mental state embracing intent to deceive, manipulate, or defraud" and leaving open the question whether reckless behavior would suffice to meet that test, 425 U.S. at 194 fn. 12, 96 S.Ct. at 1381.

Putting aside for the moment the defense of reliance on the advice of counsel, we do not regard *Hochfelder* decision as carrying the day for petitioners. The Court held that in order to create liability for damages under Rule 10b—5 and we assume in petitioners' favor that the same standard governs proceedings under § 15, *see* fn. 6—there must be proof of intention "to deceive, manipulate, or defraud"—not an intention to do this in knowing violation of the law. The Court reasoned that the language of § 10 suggested that the section "was intended to proscribe knowing or intentional misconduct,"

[6] The Court left open "the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." 425 U.S. at 194 n.12, 96 S.Ct. at 1381. The Court said nothing about whether scienter is a necessary element in disciplinary actions under § 15. These actions share with damage suits the quality of visiting serious consequences on past conduct, even though they also have a remedial effect. They thus differ from injunctive proceedings, the objective of which is solely to prevent threatened future harm, although unlawful conduct is necessary—if not always sufficient—to demonstrate the reality of this threat. We therefore assume, *arguendo*, without deciding, that the *Hochfelder* culpability standard applies in disciplinary proceedings. Cf. Jaffe, Judicial Control of Administrative Action 267-68 (1965) ("Revocation, indeed, seems often to be used as a sanction not so much to control the respondent as to warn others, and thus it has significant 'penal' components, even though the courts may choose to mask its character by calling it a 'civil' remedy.") (footnote omitted).

425 U.S. at 197, 96 S.Ct. at 1383.[7] It thought that use of such words as "manipulative" "device," and "contrivance" made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence," 425 U.S. at 199, 96 S.Ct. at 1384. And it referred, 425 U.S. at 202, 96 S.Ct. at 1385 to the oft-cited testimony of a sponsor of the Act before the House Committee on Interstate and Foreign Commerce that what became § 10(b) says 'Thou shall not devise any other cunning devices." While that phrase could not be regarded as including negligence, it reads precisely on what petitioners did here—charging the full NYSE commission rates on IOS generated OTC transactions of rebating half of these to IPC, a subsidiary of IOS, knowing that

[7] Indeed, even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally necessary for conviction. The first proposition seems implied by the rule *ignorantia juris non excusat*. Hall, Criminal Law 288 (2d ed. 1961). And the second, of course, follows from the first. Perkins, Criminal Law 745 (2d ed. 1969). See ALI, Model Penal Code §§ 1.13(12), 2.02(2)(a) & (b); *Ellis* v. *United States*, 206 U.S. 246, 257, 27 S.Ct. 600, 602, 51 L.Ed. 1047 (1907), where, in rejecting a claim that knowledge of the law was required for conviction under a statute that included the word "intentionally", Justice Holmes said, "If a man intentionally adopts certain conduct in certain circumstances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent." And see *Tager* v. *SEC, supra*, 344 F.2d at 8:

> We have recently held that a finding of actual knowledge is not necessary for finding criminal liability under § 24 of the Securities Act, 15 U.S.C. § 77x for "willful" violations of §§ 5(a) and (c) and 17(a), 15 U.S.C. §§ 77e(a), (c), and 77q(a). *United States* v. *Benjamin*, 328 F.2d 854, 863 (2 Cir.), cert. denied, 377 U.S. 953, 84 S.Ct. 1631, 12 L.Ed. 497 (1964). As Professor Loss reminds us, "It is conceivable, therefore, that 'willfully' means something less in § 15(b) than it does in the penal provisions of the SEC acts." 2 Loss [Securities Regulation] 1309. It is inconceivable that it means something more.

IPC would retain the sums paid to it although these should have been turned over to the funds directly or applied to reduce the advisory fee. It is no answer that petitioners may not have realized that this "cunning device" was a fraud.

We likewise reject petitioners' argument that there was no violation of Rule 10b—5 because they acted on the advice of their counsel, Mr. Conwill. We are not required to consider the Commission's arguments that the conduct was so flagrant a fraud that advice of counsel could never be a defense or that such advice must be disregarded because Mr. Conwill informed petitioners that his advice ran counter to a position as to the illegality of give-ups on OTC transactions taken by the Commission's staff and indeed by the Commission in PPI. It is a sufficient answer that, with all respect for Mr. Conwill's knowledge and experience, he was not in a position to give petitioners wholly disinterested advice and petitioners could not have reasonably have thought he was. Although Cowett of IOS apparently was the architect of the plan here attacked, Conwill was counsel for IOS and his primary concern lay, as petitioners must have known, in promoting its interests by assisting Cowett. Petitioners say it was natural for them to turn to him, since he was so familiar with IOS' settlement with the SEC. But this familiarity could have been at the disposal of independent counsel retained by petitioners; alternatively petitioners could have retained Mr. Conwill and then had independent outside counsel check his advice. Petitioners also note that, in addition to being counsel for IOS, Conwill was a director of FOF so that they were justified in believing that he was giving proper heed to the interests of the funds. We cannot regard the wearing of this additional hat as relieving Conwill of the interest he had as IOS' counsel in giving his sanction to an arrangement so advantageous to it. Pe-

titioners' reliance on his advice goes not to the violation, but to the penalty.

(5) The points that initially gave us most concern were petitioners' claims that many other NYSE firms, including some of high reputation, made give-ups or conferred other benefits on IPC in connection with OTC transactions initiated by IOS and that the only other firms disciplined in connection with IPC's receipt of give-ups, Hertz, Warner & Co. and Dishy, Easton & Co., together with certain principals, were only suspended from certain activities for short periods pursuant to settlement offers. Securities Exchange Act Releases No. 8874 and No. 8702. Petitioners' argument is not simply a protest against selective enforcement. They claim that the prevalence of the practice of customer-directed give-ups on OTC transactions weighs heavily against the SEC's contention that it was a violation of law.

Examination of the record indicates that both the selective enforcement claim, to which in any event *Oyler* v. *Boles,* 368 U.S. 448, 454-57 (1962), would be a formidable obstacle, and the prevailing practice argument are considerably overstated. The record does demonstrate that other firms gave up to IPC in connection with OTC transactions. However, the exhibits prepared from IPC's books showing the corporation's receipt of reciprocal and directed income were not confined to OTC give-ups, and it seems indisputable that the activity of Lipper Corp. in this regard was far greater than that of these other firms. More important, in the view we take of the case, namely, that the SEC was not obligated to predicate liability on the broad basis that any OTC give-up was a *per se* fraud but could and did rely on the fact that petitioners made give-ups to IPC, knowing that this was an 80%-owned subsidiary of IOS and that no sales or research service was furnished in return, the evidence is much less significant. For nothing in the record

shows that the other brokers who made OTC give-ups or conferred other benefits on IPC were aware of the latter facts. The evidence thus does not establish widespread belief in the legality of what petitioners did—for whatever bearing that might or might not have. The effect of the evidence of widespread give-ups and other benefits to IPC on OTC business, like the advice of counsel defense, goes rather to the penalty.[8]

IV. *The Penalty*

As stated, the ALJ rejected the staff's recommendation that Lipper Corp.'s certificate of registration should be cancelled and that Lipper should be barred and instead proposed a 12 month suspension, a period which expired in late October, 1976. The Commission adopted the staff recommendation.

Wright v. *SEC,* 112 F.2d 89 (2 Cir. 1940), might appear to be an obstacle to our altering the penalty chosen by the Commission. In *Wright,* review was sought of an SEC order expelling the petitioner from several national security exchanges and the court held that only one of

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[8] Petitioners raise the point, made in their unsuccessful petition to the SEC for rehearing, that they were denied due process because although three of the four commissioners then in office heard oral argument on August 28, 1972, only one of these, Commissioner Loomis, joined in the decision of October 1975—the other three participants in the decision not having been members of the Commission in August 1972; petitioners, however, do not urge that we remand for additional oral argument because of this. Rule 21(f) of the Commission's Rules of Practice, 17 C.F.R. 201,21(f), allows a member who was not present at oral argument to participate in the decision on condition that he review the transcript of the argument and it is not contended that this was not done. There is no general constitutional right to oral argument before an administrative agency, *FCC* v. *WJR,* 337 U.S. 265, 274-77, 69 S.Ct. 1097, 93 L.Ed. 1353 (1949), and the Commission's rule represents a reasonable accommodation of the interest—one almost essential in these days when many agency members serve so briefly. See *Gearhart & Otis, Inc.* v. *SEC,* 121 U.S.App.D.C. 186, 348 F.2d 798 (1965).

the two findings of violation was justified. Still, a majority of the panel apparently thought that a reviewing court was "without power to supervise" the Commission's choice of sanction, although Judge Swan, the author of the opinion, disagreed:

> The petitioner urges that the order of expulsion is unduly harsh; that an order of suspension would have accorded investors all the protection they need. So far as appears this was Wright's first infraction of the statute. For many years he has been operating in Wall Street and his transactions in Kinner stock are the only blemish upon his reputation. There is nothing to indicate that he is an habitual manipulator or would be likely to try to manipulate the market in the future. To deprive him for all time of an opportunity to pursue his calling in a lawful manner does seem severe. But a majority of the court hold the view that we are without power to supervise the Commission's discretionary determination that expulsion of the petitioner is necessary and appropriate for the protection of investors. The writer of this opinion does not share that view, believing that under the power conferred upon this court to "modify", as well as to affirm or to set aside an order in whole or in part, we may reduce the relief accorded investors. My own opinion is that the Commission should be directed to reduce it.

112 F.2d at 95-96.[9]

[9] The court then remanded to the Commission for its reconsideration of the penalty in view of the holding that one of the alleged violations was insufficiently shown. See 112 F.2d at 96. On remand, the Commission adhered to its determination of expulsion, *In the Matter of Charles C. Wright*, 12 SEC 100 (1942), and this was upheld on further review, *Wright* v. *SEC*, 134 F.2d 733 (2 Cir. 1943).

Numerous cases in this circuit since *Wright*, however, while not expressly repudiating that decision, have assumed that Commission-ordered penalties are reviewable as to severity although none apparently considered the sanction under review so harsh as to require that it be set aside. *See e. g., Berko* v. *SEC*, 316 F.2d 137, 141-42 (1963); *Tager* v. *SEC*, 344 F.2d 5, 9 (1965); *Hanly* v. *SEC*, 415 F.2d 589, 598 (1969); *Fink* v. *SEC*, 417 F.2d 1058, 1060 (1969); *Gross* v. *SEC*, 418 F.2d 103, 107 (1969); *Sinclair* v. *SEC*, 444 F.2d 399, 402 (1971). See also *Boruski* v. *SEC*, 289 F.2d 738 (1961); *Nassau Securities Service* v. *SEC*, 348 F.2d 133, 136 (1965).[10] Compare *Jacob Siegal Co.* v. *FTC*, 327 U.S. 608, 612, 66 S.Ct. 728, 90 L.Ed. 888 (1946). Reviewability of sanctions would seem to be authorized by application of the Administrative Procedure Act, see 5 U.S.C. §§ 551(10) & (13), 702, 706, the enactment of which adequately explains why *Wright's* suggestion that an agency's discretionary choice of sanctions cannot be altered has not been followed.[11] See also Jaffe, Judicial Control of Administra-

[10] Courts in other circuits similarly have reviewed SEC sanctions on an abuse of discretion or arbitrary or capricious standard. See, e.g., *Nees* v. *SEC*, 414 F.2d 211, 217 (9 Cir. 1969); *O'Leary* v. *SEC*, 424 F.2d 908, 912 (D.C.Cir. 1970); *Beck* v. *SEC*, 430 F.2d 673 (6 Cir. 1970) (setting aside four month suspension as a "gross abuse of discretion"); *Quinn & Co.* v. *SEC*, 452 F.2d 943, 947 (10 Cir. 1971), *cert. denied*, 406 U.S. 957, 92 S.Ct. 2059, 32 L.Ed.2d 344 (1972). See also *American Power Co.* v. *SEC*, 329 U.S. 90, 112-13, 67 S.Ct. 133, 146, 91 L.Ed. 103 (1946), where the Court stated that an SEC remedial action would be set aside "only if the remedy chosen is unwarranted in law or is without justification in fact," a standard more recently applied to the review of an administrative sanction in *Butz* v. *Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182, 93 S.Ct. 1455, 36 L.Ed.2d 142 (1973).

[11] Indeed, the Commission does not contend here that the order is in any sense unreviewable, urging instead that judicial disturbance of such orders is limited to cases of abuse of discretion. Respondent's Br. at 63.

tive Action 270-71 (1965)("It is not in accord with current concepts of justice that the exercise of such drastic powers [to revoke or suspend a license] should be totally beyond revision, particularly where exercised by our monolithic, policy-oriented agencies."); Schwartz & Wade, Legal Control of Government 270 (1972) ("One of the limitations of the administrative expert is his tendency to single-mindedness and excessive zeal. The judges can stand apart from the tensions of the immediate case and mitigate the enthusiasm of the expert by the community's sense of justice."). Given our power to review SEC penalty determinations, our authority to limit such sanctions in appropriate cases seems necessarily to follow.

Coming then to the question of the appropriateness of the Commission's sanction, we think it was too severe.[12] Clearly it is unnecessary to prevent petitioners from again doing what they did, since all customer-directed give-ups have been abolished since December 5, 1968. The purpose of such severe sanctions must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases. Viewed in bald outline and in the light of hindsight, petitioners' conduct may indeed seem egregious. But, as conceded by the Commission in an *amicus* brief filed in this court in *Tannenbaum* v. *Zeller*, No. 75-7503, the years 1967 and 1968 in which petitioners engaged in unlawful give-ups were years of considerable uncertainty as to the regulatory climate concerning give-ups; the Com-

[12] Under the circumstances of this case we give little weight to the Commission's protestations that persons once barred might be readmitted to the securities business under proper supervision. See *Tager* v. *SEC*, supra, 344 F.2d at 9. Whatever the force of this in the case of a registered representative, Lipper is hardly interested in returning to the business as a minor salesman in a large brokerage firm. Moreover, eight years have already elapsed since the conduct of which the SEC complains.

mission was torn between its desire to move away from uniform fixed commission rates, a movement which would eliminate the economic basis for customer-directed give-ups, and its belief that existing give-up opportunities should be utilized by investment advisers for the benefit of shareholders in mutual funds. True, there was nothing in all this that should have induced a belief that give-ups could be utilized for the benefit of the adviser rather than of the fund. Still petitioners were living in a world of customer-directed give-ups, which many other competing brokers were directing to IPC. Moreover, they did act under the supervision of experienced although in our view not disinterested counsel and, while they knew exactly what they were doing, there is no evidence that they had any thought they were violating the law—unless, of course, it were the law that any give-up on OTC business was fraudulent, which they had been advised, perhaps correctly, was not true. We are moved also by the inordinately long time in which this proceeding has been pending, particularly the unexplained lapse of over three years from the argument to the decision of the Commission, the cloud that has hung over petitioners' heads during this period and the tremendous disparity between the sanctions invoked against petitioners and that imposed on two other brokers whose violations were perhaps more clear. Finally, although the Commission is in no way bound by the views of the ALJ, *FCC* v. *Allentown Broadcasting Corp.*, 349 U.S. 358, 75 S.Ct. 855, 99 L.Ed. 1147 (1955); *Hiller* v. *SEC*, 429 F.2d 856, 858 (2 Cir. 1970), some weight may properly be given to his opportunity to observe Lipper and others who played a part in the acts here in question and in fashioning a remedy in light of that observation. *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 492-97, 71 S.Ct. 456, 95 L.Ed. 456 (1951). If this statute authorized suspension for a period longer than twelve months, and the Commission had exercised such authority to sus-

pend for say another twelve months, we surely would not interfere. But with the choices limited to a suspension of not more than twelve months or a revocation or bar, we consider that under the special circumstances of this case, selection of the latter was an abuse of discretion.

The petition to review is therefore denied except that the sanctions shall be limited to suspension of Lipper Corp.'s registration for 12 months from the date of the Commission's order and the barring of Lipper from association with any broker or dealer for the same period.

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-second day of March, one thousand nine hundred and seventy-seven.

Present: HONORABLE HENRY J. FRIENDLY
HONORABLE PAUL R. HAYS
HONORABLE WILLIAM H. MULLIGAN
Circuit Judges.

76-4067

ARTHUR LIPPER CORPORATION and ARTHUR LIPPER, III,
Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

A petition for a rehearing having been filed herein by counsel for the respondent (Securities and Exchange Commission)

Upon consideration thereof, it is

Ordered that said petition be and hereby is Denied.

/s/ A. DANIEL FUSARO,
A. Daniel Fusaro,
Clerk

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-second day of March. one thousand nine hundred and seventy-seven.

Docket No. 76-4067

ARTHUR LIPPER CORPORATION and
ARTHUR LIPPER, III, *Petitioners*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent*

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the respondent, and a poll of the judges in regular active service having been taken and there being no majority in favor thereof,

Upon consideration thereof, it is Ordered that said petition be and it hereby is DENIED.

Judge Oakes dissents.

/s/ IRVING R. KAUFMAN
Irving R. Kaufman,
Chief Judge

UNITED STATES COURT OF APPEALS, SECOND CIRCUIT

ARTHUR LIPPER CORPORATION and Arthur Lipper, III,
Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

No. 165, Docket 76-4067

Petition for Rehearing Dec. 27, 1976.

Order Denying Petition for Rehearing March 22, 1977

DISSENTING OPINION APRIL 1, 1977

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the respondent, and a poll of the judges in regular active service having been taken and there being no majority in favor thereof,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

OAKES, Circuit Judge (with whom Judge MESKILL concurs):

I dissent from the denial of rehearing en banc. Expressing no opinion on the merits, it seems to me that this case raises sufficiently important questions of administrative law and the role of the courts therein, of general applicability, to warrant our careful consideration sitting en banc. Even assuming, as the panel opinion persuasively argues, that *American Power & Light Co.* v. *SEC,* 329 U.S. 90, 112, 67 S.Ct. 133, 91 L.Ed. 103 (1946), and *Butz* v. *Glover Livestock Commission Co.,* 411 U.S. 182, 93 S.Ct. 1455, 36 L.Ed. 2d 142 (1973), permit the reviewing court to vacate an administrative sanction, which is " 'peculiarly a matter for

administrative competence,' " 329 U.S. at 112, 67 S.Ct. at 146, it is difficult to see how the reviewing court may properly substitute its judgment for that of the agency on such a matter. *O'Leary* v. *SEC,* 137 U.S.App.D.C. 420, 424 F.2d 908, 911-12 (1970); *see* K. G. Davis, *Administrative Law Treatise* § 30.10, at 250-52 (1958). Underlying precepts of administrative law would seem to require a remand for further agency consideration of the sanction if it has previously abused its discretion. I am as intolerant of the agency's delays in this case, and other agencies' in other cases, as the distinguished author of the majority opinion, but I question seriously whether those delays justify taking a leap which has, except for one "sport," *Beck* v. *SEC,* 430 F.2d 673 (6th Cir. 1970) (entire sanction set aside), not heretofore been taken, that is, the reviewing court's substituting its own judgment of what the sanction should be for that of the agency. *See, e. g. Hanly* v. *SEC,* 415 F.2d 589, 598 (2d Cir. 1969); *Marketlines, Inc.* v. *SEC,* 384 F.2d 264, 267 (2d Cir. 1967), *cert. denied,* 390 U.S. 947, 88 S.Ct. 1033, 19 L.Ed.2d 1137 (1968). If this is the unique case the panel opinion pictures it as—where the SEC had absolutely no choice under the statute, Section 15(b)(4), (6) of the Securities Exchange Act, 15 U.S.C. § 78*o*(b)(4), (6), between a year's suspension and a permanent bar—it would be one thing, but it seems to me it was entirely open to the Commission to impose a bar with leave to reapply, just as this court recommended to the Drug Enforcement Administration in *Sokoloff* v. *Saxbe,* 501 F.2d 571, 576-77 (2d Cir. 1974). I fail to see any Commission rule or requirement that readmission to the business be under supervision or, if it were, that this would be so terribly unfair to someone who ignored his fiduciary obligations and violated the Securities Exchange Act and Rules thereunder.

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 11773/October 24, 1975

Admin. Proc. File Nos. 3-2156 and 3-2157

In the Matters of

ARTHUR LIPPER CORPORATION
140 Broadway
New York, New York (8-13182)

ARTHUR LIPPER, III
IOS, LTD, (S.A.)
Geneva, Switzerland

INVESTORS PLANNING CORPORATION OF AMERICA
(now known as CIP, Inc.)
New York, New York (8-12374)

Opinion of the Commission

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Recapture by Affiliate of Commissions on Investment Company Portfolio Transactions Through Give-Ups from and Reciprocal Arrangements with Unaffiliated Broker-Dealers

Receipt of Money in Connection with Investment Company Portfolio Transactions

Over-the-Counter Give-Ups

Conflict of Laws—International Law

Where manager of unregistered off-shore investment companies selected to execute companies' over-the-counter portfolio transactions broker who paid portion of commissions on such business to manager's subsidiary, *held,*

manager, aided and abetted by broker, violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder; and gravity of misconduct required that registration of broker be revoked and that manager be barred.

Where Securities Exchange Act's antifraud provisions were violated in connection with portfolio transactions of unregistered off-shore investment companies executed in the United States, and where violators were registered broker-dealers, *held,* United States has jurisdiction to take remedial action.

Receipt by Affiliate of Compensation in Connection with Purchase and Sale of Investment Company Property

Deficient Investment Advisory Contract

Misstatements in Prospectuses, Proxy Material and Other Documents

Where registered broker-dealer who was mutual fund's principal underwriter and investment adviser procured for itself rebates of fund's brokerage commissions from unaffiliated brokers without rendering any brokerage services in return therefor, *held,* such broker-dealer and its unregistered corporate parent violated or aided and abetted violations of Securities Exchange Act's antifraud provisions and of Sections 17(e)(1), 15(a)(1), 20(a), and 34(b) of the Investment Company Act and also of Rule 20a-1 under the Investment Company Act.

APPEARANCES:

Allan F. Conwill, of Willkie, Farr & Gallagher, *John A. Dudley,* of Sullivan & Worcester, and *Howard S. Klotz,* for Arthur Lipper Corporation and Arthur Lipper, III.

Calvin H. Cobb, Jr., Robert M. Goolrick, Edmund B. Frost, and *W. John Amerling,* of Steptoe & Johnston, for IOS, Ltd. (S.A.) and Investors Planning Corporation of America.

Stanley Sporkin, Marvin E. Jacob, Robert M. LaPrade, Joanne Leveque and *Robert L. Anthony,* for the Division of Enforcement of the Commission.

I. *INTRODUCTION*

This case is about the once vast international financial complex controlled by IOS, Ltd. (S.A.) ("IOS").[1] More specifically, it is about IOS's handling of the large volume of brokerage business generated by the enormous pools of other people's money under its management and about the way in which IOS used that brokerage business to serve its own interests rather than those of the investors who had entrusted their savings to it. The transactions in question were executed in the over-the-counter market and on the New York Stock Exchange.

In 1967 and 1968, the period involved in this case, brokers executed all stock exchange orders at fixed rates. These rates varied with the price per share of the security. But the commission was calculated on a per share basis. The commission on an order for 10,000 shares of a given stock was exactly 100 times that on an order for 100 shares of the same stock. Brokers found it profitable and were eager to handle transactions for investment companies and other institutional customers because the cost of handling large orders did not increase proportionately with the commissions they were obligated to charge. This was so much the case that brokers were willing and anxious to execute large institutional orders for substantially less than the fixed minimum commission rate. Since the commission could not be reduced, brokers were willing, at the custom-

[1] The initials stand for Investors Overseas Services.

er's direction, to pay over part of the commission to other brokers within the rules of the stock exchange. Thus, large institutional investors had substantial amounts of so-called "excess brokerage" (*i.e.*, that portion of the commission that the executing broker was willing to give up) at their disposal.[2]

II. *THE ADMINISTRATIVE LAW JUDGE'S INITIAL DECISIONS*

The administrative law judge before whom the hearings were held concluded that:

> 1. Brokers who executed transactions for, and who therefore received commissions from, members of the complex of mutual funds managed by IOS[3] surrendered portions of those commissions to an IOS subsidiary known as Investors Planning Corporation of America ("IPC").[4] This was done at IOS's direction.
>
> 2. Neither IOS nor IPC[5] rendered any brokerage services to the funds in whose commission disbursements they shared.

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[2] In theory, only the minimum rate of commissions was fixed. Brokers were free to go higher if they wished. And, in fact, brokerage houses sometimes charged more than the minimum on small transactions or even refused to handle them at all. By and large, however, the minimum was also the maximum.

[3] A group of mutual funds under common management is called a "fund complex." *See Report of the S.E.C. on Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 45-47 (1966) [hereinafter cited as Public Policy]. *See also* Glazer, *A Study of Mutual Fund Complexes*, 119 U. Pa. L. Rev. 205 (1970).

[4] IOS owned eighty percent of the outstanding IPC stock. After the events dealt with in this opinion, IPC changed its name to CIP, Inc.

[5] Hereinafter sometimes referred to collectively as "the IOS respondents."

> 3. The money surrendered by the executing brokers to the IOS respondents belonged in equity and good conscience to the funds out of whose commissions it came. When the IOS respondents appropriated that money for themselves, they breached their fiduciary duties to the funds under their management. This breach of duty and the failure to disclose it to actual and prospective investors in those funds were in willful violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.
>
> 4. Fund of America, Inc. ("FOA") was registered with us as an investment company under the Investment Company Act. When the IOS respondents took a portion of that fund's excess brokerage, they violated various provisions of the Investment Company Act.
>
> 5. The IOS respondents' violations were serious. It is in the public interest to bar IOS itself from association with a broker or dealer. But IPC's situation is different. It is no longer controlled by or affiliated with IOS. Since its wrongdoing stemmed from its former relationship to IOS, a nine-month suspension of IPC's broker-dealer registration is enough to satisfy the public interest.
>
> 6. Arthur Lipper Corporation ("Lipper Corp."), a New York City broker-dealer, and during the relevant period, a New York Stock Exchange member firm and also a member firm of other domestic securities exchanges registered with this Commission under the Securities Exchange Act, was organized to handle the large brokerage business for IOS-managed funds. Substantial portions of the commissions received from such business were surrendered to IPC. Thus, the Lipper firm was a knowing participant in the IOS

respondents' fraudulent scheme. And so was its founder, president and controlling stockholder, Arthur Lipper, III. Lipper and his firm[6] willfully aided and abetted some of the IOS respondents' violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

7. It would be in the public interest to suspend the Lipper firm from effecting transactions in the over-the-counter market for twelve months. During that period, Lipper himself should be suspended from association with any broker or dealer.

An independent review of the record leads us to agree with the administrative law judge's analysis.[7] We are also in accord with his view that it is in the public interest to preclude IOS from associating itself with brokers or dealers in the future. But we see no need at this juncture for remedial action against IPC. And we also disagree with the administrative law judge about the nature of the sanctions against the Lipper respondents called for by the public interest. As to that, we agree with our staff that suspension is not enough and that the Lipper respondents ought to be barred from the securities business.

Our reasons for so holding are stated below.

III. *THE IOS COMPLEX*

During the 1950's and the 1960's the basic trend in the American equity securities markets was upward. In those

[6] Hereinafter sometimes referred to collectively as "the Lipper respondents."

[7] The respondents petitioned for review of the administrative law judge's decision. Our Division of Enforcement also sought review with respect to what it considers the gross inadequacy of the sanctions imposed on the Lipper respondents. After granting all of the petitions for review, we received briefs from all parties and heard oral argument.

years, the American mutual fund industry grew dramatically.[8] These developments led foreign investors to take a favorable view of American mutual funds, and facilitated the sale of their shares abroad.

IOS capitalized on this market.[9] It did so by means of the so-called "off-shore fund." That involved the formation by IOS of investment companies in countries other than the United States.[10] Those entities sold their shares outside the United States. But they invested the proceeds largely or wholly in United States securities, using our securities markets to do so. IOS created off-shore funds, managed them after their creation, and sold their shares in many countries.

During the period of concern to us here, IOS, a Panamanian corporation that maintained its principal offices in Switzerland, controlled IPC, a large New York City-based United States broker-dealer registered as such under the Exchange Act. IPC had little or no general securities business. Its primary activity was the retail sale of mutual fund shares to Americans here in the United States. Like many other mutual fund retailers, IPC sold the public shares in many different mutual funds. But it had nothing whatever to do with the management of those funds.

[8] This theme was expounded at length in Public Policy.

[9] IOS's first idea was the fund holding company, The Fund of Funds ("FOF") formed for the purpose of investing in American mutual funds registered and regulated under the Investment Company Act and in publicly-held mutual fund management companies. *See Public Policy* 311-324. But by the time dealt with in this opinion the original concept had been broadened so that it included direct investment in the stocks and bonds of United States companies engaged in industry and trade.

[10] The name "off-shore" is said to reflect the fact that many of the funds were set up on the islands off the shores of the United States. Note, *United States Taxation and Regulation of Off-Shore Mutual Funds*, 83 Harv. L. Rev. 404, 405 n.10 (1969).

IPC, however, was more than a mere retailer of shares in mutual funds that were managed by others. It also had its own "in-house" fund for which IPC acted as investment adviser and principal underwriter. This fund was FOA, a corporation organized under New York law. There was nothing "off-shore" about FOA. It was just another domestic mutual fund. Like hundreds of similar funds, it was subject to the Investment Company Act and registered with us under that statute as an open-end investment company.

IPC's domestic mutual fund retailing operation was much older than IOS. In April 1965, IOS bought a controlling interest in IPC's going (albeit then unprofitable) retail mutual fund business.[11] After that, IOS naturally wanted to make IPC profitable. One way of doing this was to build up IPC's captive fund, FOA.

As a mere merchandiser of shares in mutual funds controlled by others, IPC could expect only the retail dealer's share of the sales charge plus some excess brokerage income funneled to it by the managers of the funds whose shares it was selling. But when IPC sold shares in FOA, it:

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[11] IOS attributed the losses to IPC's "unimaginative" management. An IOS official testified that IPC was acquired because it "represented an opportunity for IOS to come into the United States market, building from a base of a reasonably large and well-established broker-dealer." IPC had a 5,000-man sales force at the time of its acquisition by IOS. It appears that this sales force consisted for the most part of what a study by the staff of our Office of Economic Research described as "armies of salesmen who are believed to be worthwhile even if they only sell themselves, their close friends, and their relatives." S.E.C. Staff Report *On the Potential Economic Impact of a Repeal of Section 22(d) of the Investment Company Act of 1940*, p. A-49 (November 1972). *See also id.* at pp. A-63 - A-64 (referring to "legions of unproductive low-income salesmen").

1. Kept the total sales charge since there was no unaffiliated wholesaler or principal underwriter with whom that charge had to be divided;[12] and

2. Enhanced its advisory fee income because the sale of new shares increased the volume of assets on which the fee paid to IPC by FOA was based.[13]

So IOS made FOA grow.[14] It did that in two ways. First, it caused IPC's sales force to push FOA and to deemphasize what had theretofore been that sales force's primary pursuit, the sale of shares in mutual funds unaffiliated with IPC. Second, IOS put money from one of its own off-shore funds into FOA. IOS's foreign mutual fund holding company, FOF,[15] bought into FOA in a big way. From July 1965 to August 1966, FOF invested approxi-

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[12] Mutual fund sales charges tended to cluster around the 8.5 percent level. Thus, when an investor wrote a check for a thousand dollars to pay for a purchase of "load" fund shares, only $915 of that sum actually went to the fund for investment. The other $85 was consumed by the sales charge, which went to those who made the sale. During the relevant period, it was usual for principal underwriters to retain two percent of the investor's total payment (or about 25 percent of the aggregate sales charge) for themselves. The balance went to the retail dealers and the salesmen who did the actual selling. Public Policy 207-209.

[13] Over the long-run, this was much more important than sales charge revenues. Generally, the advisory fees that the adviser-underwriters receive for their managerial services are based on the size of the asset pools under management. Since the size of a mutual fund does not fluctuate nearly as much as the sale of new shares, the advisory fee provides a stable source of income.

[14] FOA had only about $5 million in assets when IOS came into the picture. A year and a half later (on November 30, 1966) FOA's assets were around $44 million.

[15] *See* n.9 on p. 5, *supra*.

mately $22 million in FOA. By mid-1966, FOF owned about 46 percent of FOA's outstanding shares.[16]

FOF's investment in FOA was a highly-remunerative proposition for IOS. The benefits to FOF itself or its shareholders were more obscure, to say the least. By having one of its funds, FOF, invest in FOA, another IOS-managed fund, IOS:

> 1. Collected a sales charge on a sales charge—because the investor who bought FOF shares and who paid a sales charge to IOS at that time also bore the burden of the sales charge later paid by FOF to IPC (but inuring, of course, to the benefit of IPC's parent, IOS) when FOF purchased FOA shares from IPC, the exclusive distributor of those shares;[17] and
>
> 2. Received two advisory fees out of what was in economic reality a single pool of capital—IOS took an advisory fee from FOF in exchange for its services in putting FOF's money into FOA, and through IPC it then took a second advisory fee from FOA for managing FOA's investments.[18]

IV. *THE 1966 PROCEEDING AND ITS AFTERMATH*

Soon after IOS's acquisition of IPC, members of the Commission's staff reported to the Commission that infor-

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[16] Public Policy 313, Table VIII-1. The record shows that in January 1968 FOF still owned approximately 40 percent of FOA's shares.

[17] There were so many entities in the IOS complex that the above text simplifies the corporate relationships involved. FOA's underwriter was IPC, and FOA's adviser was IPC's wholly-owned subsidiary, Fund of America Management Corporation.

[18] As we said in Public Policy: Inherent in the fund holding company structure is a layering of costs including advisory fees, administrative expenses, sales loads, and brokerage fees, all of which serve to make a fund on funds a particularly expensive investment vehicle." Public Policy at 318.

mation had come to their attention indicating that IOS's assertedly off-shore funds were not wholly off-shore. Our staff believed that shares in those funds had been offered and sold to an appreciable number of Americans fraudulently and in violation of the Securities Act's registration requirements.[19] To determine whether this was actually so and what remedial action, if any, was needed, this Commission, in February 1966, instituted an administrative proceeding against IOS and some of its affiliates.[20] After the failure of its strenuous efforts to enjoin that proceeding on the ground that we had no power to conduct it,[21] IOS decided to settle.

During settlement negotiations with our staff, IOS learned that settlement would require a material reduction in the scope of its United States activities. IOS made an offer of settlement in which it undertook, among other things, to:

> 1. Divest itself of IPC within a specified time;
>
> 2. Cease selling securities to United States citizens and nationals wherever located, except, *inter alia,* for sales by IPC during its continued ownership of that entity;
>
> 3. Make a rescission offer to Americans who held interests in FOF;
>
> 4. Withdraw its own broker-dealer registration and the registrations of those of its affiliates that were then registered with us as brokers and dealers; and

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[19] Our staff also believed that violations of the Investment Company Act had been committed.

[20] Administrative Proceeding No. 3-497 instituted by order of February 3, 1966. This proceeding is referred to as "the 1966 proceeding."

[21] *See Fontaine* v. *S.E.C.,* 259 F. Supp. 880 (D.P.R., 1966).

5. Conduct all of its securities activities outside the United States.

We accepted IOS's offer on May 23, 1967, thus terminating the 1966 proceeding.[22]

Before that time, IOS began to prepare for the day when it would have to dispose of IPC and place all orders for United States securities abroad through an independent foreign brokerage firm or through an independent United States brokerage firm with a foreign branch office. IOS chose Lipper as a broker for the funds managed by it. At IOS's instance, in March 1967 Lipper organized Lipper Corp., headquartered in New York, with branch offices in London and Geneva. He did so for the primary purpose of acting as a broker for the funds managed by IOS and after assurances from it of sufficient business from "IOS generated sources to cover the kind of investment involved." [23] The "investment involved" was needed to establish an elaborate communications network for transmitting the orders that the IOS-managed funds placed with Lipper Corp's foreign branches to its main office in New York. Through this network those foreign funds continued to buy and sell United States securities in this country's markets rather than those abroad.

As for IPC, the settlement agreement granted IOS a period of time before it had to sell its shares of IPC, and this was ultimately accomplished in the fall of 1968. Of course, the price that IOS could expect to obtain for its IPC shares obviously depended on the latter's earning power. IOS, therefore, had an especially strong incentive

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[22] *IOS, Ltd. (S.A.)*, Securities Exchange Act Release No. 8083.

[23] From April 1967 through June 1968, Lipper Corp. received gross commissions of $11,372,000, $8,014,000 of which came from IOS-related business.

to improve IPC's performance prior to the sale. The Lipper respondents helped IOS to attain that objective.

V. *REBATES OF OVER-THE-COUNTER BROKERAGE COMMISSION*

A. *The Facts and Their Legal Consequences*

Lipper Corp. handled the foreign funds' over-the-counter business on an agency business. For its services in this regard, Lipper Corp. charged the stock exchange commission rate. But it kept less than half of the resulting gross commissions. The rest of them were paid over—"given up" in the jargon of the trade—to IPC. These give-ups by Lipper Corp. to IPC totaled about $1,450,000 from July 1967 to August 1968. In view of IOS's relationship to IPC, that money was for all practical purposes given up to IOS.

Since neither of the IOS respondents performed any brokerage function in connection with the over-the-counter transactions handled by Lipper Corp., it is apparent that they did nothing in return for the income that they derived from those transactions.[24] They simply caused the funds to divert $1,450,000 to them. Lipper Corp. was a mere conduit for the diversion. No extended discussion is required to demonstrate that this was a gross breach of fiduciary duty by the IOS respondents.[25]

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[24] It is true, of course, that IOS managed the funds and that this involved work. But IOS was getting a management fee for these services.

[25] Investment advisers are fiduciaries. *S.E.C.* v. *Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963); *Arleen W. Hughes*, 27 S.E.C. 629, 635-638 (1948), *aff'd sub. nom. Hughes* v. *S.E.C.* 174 F. 2d 969 (C.A.D.C., 1949). And investment advisers to investment companies are on the same footing. *Rosenfeld* v. *Black*, 445 F. 2d 1337 (C.A. 2, 1971), *petition for cert. dismissed* 409 U.S. 802 (1972); *Brown* v. *Bullock*, 194 F. Supp. 207, 229 (S.D.N.Y. 1961),

Such "disregard of trust relationships by those whom the law should regard as fiduciaries" was one of the evils that the Exchange Act sought to eliminate.[26] We therefore find, as did the administrative law judge, that the IOS respondents' over-the-counter commission-splitting arrangements were a fraud on the foreign funds and on their shareholders.[27] It follows that the IOS respondents

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aff'd 294 F. 2d 415 (C.A. 2, 1961). *See Provident Management. Corp.*, 44 S.E.C. 442, 447 (1970): "Porteous and Lautsbaugh, as officers of Fund and as persons responsible for directing the execution of its portfolio transactions, and Management by virtue of its position as investment adviser, were fiduciaries of Fund. As such, they were under a duty to act solely in the best interest of Fund and its shareholders. . . . While there is no proof that Fund did not receive the best execution on its transactions, or that the existence of the arrangement described resulted in additional costs to Fund, once the reciprocal arrangements were made, it was improper for Porteous & Co. to keep for itself rather than confer on Fund the benefits attributable to Fund's assets."; *Consumer-Investor Planning Corp.*, 43 S.E.C. 1096, 1100-1101 (1969): It is clear that [respondents] . . . placed the purchase and sale of the Fund's portfolio securities with those brokers who would pay over to them the largest extractable portions of the brokerage commissions thus generated and the most substantial other benefits. The payments and benefits received by them did not represent compensation for any services rendered to or benefits conferred upon the Fund, but rather constituted a form of personal enrichment derived from the Fund's portfolio transactions. By such blatant trafficking of the Fund's business, respondents simply used their fiduciary positions in relation to the Fund to cause monetary and other benefits to inure to themselves without regard to what was best for the Fund. . . . The abuse of position and conflict of interests inherent in the making of these arrangements was clearly inimical to the Fund and its shareholders." *Delaware Management Co.*, 43 S.E.C. 392 (1967).

[26] H.R. Rep. 1383, 73d Cong., 2d Sess. 6 (1934).

[27] Respondents contend that their over-the-counter commission arrangements were disclosed to the directors of the foreign funds. Like the administrative law judge, we find this contention unsupported by the record. Three foreign funds were involved. The Lipper-IPC give-up arrangements are claimed to have been discussed at a meeting of one of the three boards. But what about the boards of the other funds? No disclosures are expressly claimed to have been made to them. As to the disclosures made to the one fund, we agree with the administrative law judge that they cannot be deemed to have been adequate. But even if they had been adequate so far as the directors were concerned, it seems to use that in view of IOS's controlling influence over these entities, the disclosure required in this situation was disclosure to the shareholders actual and prospective. Moreover, the administrative law judge pointed out that the person making the purported disclosures was a principal in the scheme to defraud the foreign funds. *Cf. Schoenbaum* v. *Firstbrook*, 405 F. 2d 200, 211-212, *reversed in part on other grounds en banc* 405 F.2d 215 (C.A. 2, 1968), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906 (1969):

willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Since the Lipper respondents knew about IOS's relationship to the foreign funds, and since their active assistance was an essential element of the scheme, they were clearly participants in the IOS respondents' breach of trust. It follows that the Lipper respondents willfully aided and abetted the IOS respondents' violations.[28]

Respondents advance various arguments, based upon then existing rules and practices in the securities markets

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"In general, if the corporation's agents have not been deceived, neither has the corporation. However, as in other situations governed by agency principles, knowledge of the corporation's officers and agents is not imputed to it when there is a conflict between the interests of the officers and agents and the interests of the corporate principal. [Citations omitted.] Therefore, a corporation may be defrauded in a stock transaction even when all of its directors know all of the material facts, if the conflict between the interests of one or more of the directors and the interests of the corporation prevents effective transmission of material information to the corporation, in violation of Rule 10b-5(2)." *See also Pappas* v. *Moss*, 393 F. 2d 865 (C.A. 3, 1968).

[28] *See Provident Management Corp.*, 44 S.E.C. 442, 448 (1970).

which, they claim, justify their activities. To these we now turn.

Respondents claim that the rules of the New York Stock Exchange required the funds to bear over-the-counter brokerage costs that are conceded to have been high. They argue that:

> 1. As a New York Stock Exchange member, Lipper Corp. was bound to adhere to that organization's minimum commission rate schedule.
>
> 2. The anti-rebate rules that the exchange adopted for the purpose of preventing its members from cutting rates in underhanded ways precluded Lipper from returning any excess brokerage to the funds themselves.
>
> 3. There were only two choices. One was for Lipper to retain for himself all of the brokerage that the New York Stock Exchange had thrust into his unwilling hands. The other was to divide it with IOS. In no event could the funds' over-the-counter brokerage costs have been any lower than they actually were.

This argument, although perhaps superficially appealing, is, upon analysis, unavailing. The New York Stock Exchange had no jurisdiction over commission rates in over-the-counter transactions. The over-the-counter market during the relevant period was, and it still is, "a negotiated market . . . not governed by fixed prices or minimum commision rate schedules."[29] Therefore, "any will-

[29] Public Policy 178. Although the practice was to charge the New York Stock Exchange minimum rate on over-the-counter transactions executed on an agency basis, no rules legally binding on Lipper required this. A violation of the National Association of Securities Dealers' Rules of Fair Practice might have been involved, however, if the commission charged was in excess of the New York Stock Exchange minimum.

ingness of the executing broker . . . to allow his customer to direct a give-up of a portion of his commission . . . in and of itself shows that a lower . . . commission could have been negotiated."[30]

The New York Stock Exchange's anti-rebate policies are clearly not relevant here. Those policies applied only to transactions on that exchange. What they prohibited was the division of commissions paid for such transactions with those who were not themselves members of the New York Stock Exchange.[31] The transactions involved herein were not New York Stock Exchange transactions.[32] Nor was IPC a New York Stock Exchange member. The Lipper respondents claim to have been in fear of disciplinary action by the New York Stock Exchange.[33] But they

[30] Public Policy 178.

[31] Public Policy 170.

[32] The New York Stock Exchange's vice president in charge of member firms testified that "The New York Stock Exchange minimum commissions applied to New York Stock Exchange trades, not over-the-counter trades." The following colloquy then ensued:

> "Q To what extent does the New York Stock Exchange feel it has the authority to establish rates in the over-the-counter market?
>
> A We don't feel that we have any authority to establish rates in the over-the-counter market."

[33] The New York Stock Exchange official previously referred to did testify that very low over-the-counter charges might in certain circumstances be deemed impermissible rebates. But he made it clear that he was talking about over-the-counter commissions that were below the cost of doing business. He further testified as follows on redirect examination by Division counsel:

> "Q Now Mr. Bishop, is it a requirement of the New York Stock Exchange [sic] be charged by member firms in executing over-the-counter transactions, even though the minimum New York Stock Exchange Commission exceeds the cost of executing the transaction?
>
> A No."

have never explained why this fear did not restrain them from giving up to IPC.[34] If the New York Stock Exchange's rules had been applicable to these transactions, they would have prohibited commission-splitting with IPC as well as with the funds that paid those commissions.

Moreover, the New York Stock Exchange had no jurisdiction over IPC. There is nothing in the record to show that the exchange would have been disconcerted had IPC returned Lipper's give-up money[35] to the funds.[36] Hence the administrative law judge was clearly correct when he held that:

> "There was no requirement of the NYSE that its members charge NYSE rates on over-the-counter transactions and Cowett [IOS's executive vice president and the principal architect of the give-up scheme] and Lipper, both highly sophisticated in the financial world, knew or should have known the limitations of the NYSE rules. It was permissible for Lipper Corporation to charge less on the funds' over-the-counter transactions and, contrary to respondents' position, the record evidences a willingness by Lipper Corporation to be content with 50% of the amounts actually charged the funds on such transactions. In this connection, it is also clear from the record that Cowett was not interested in negotiating for a lower rate but in having Lipper Corporation give up 50% of the funds' commission payments to IPC so that the latter would obtain additional revenues."

[34] Lipper testified:

> "Q Weren't you concerned that the New York Stock Exchange might consider the payment of commissions earned in the over-the-counter market, for Fund of Funds portfolio transactions, to IPC, as violative of their anti-rebate rules?
>
> A No sir, I was not concerned."

[35] During the relevant period, the New York Stock Exchange permitted one of its members to manage a large investment company complex without receiving any management fee. The partners in that firm viewed the brokerage income that they derived from the complex's portfolio transactions as sufficient in itself to compensate them for their services. There is no indication that the Exchange considered this arrangement an impermissible rebate. *See* Public Policy 106-109.

[36] Whatever the New York Stock Exchange's sentiments might or might not have been, the money having come from the funds in the first place, and IPC having done nothing to earn it, there was no way in which the IOS respondents could lawfully keep it. *Moses* v. *Burgin*, 445 F.2d 369, 376 n. 11 (C.A. 1, 1971), *cert. denied* 404 U.S. 994 (1971).

Respondents say that customer-directed give-ups were widespread and generally regarded as legitimate in 1967 and 1968. They are right about that. But their conclusion that this justifies the activities here involved, however, is unfounded because the customer-directed give-ups referred to, which were in the exchange market, differed from the present case in two critical respects. First, they did not involve fiduciaries diverting their beneficiary's funds into their own pockets. Secondly, they represented a form of competition for lucrative institutional business that prevailed under the rigid fixed commission rate system which existed in the exchange markets only.

Exchange rules fixed minimum commissions at a rate which often exceeded the amount for a which a broker was willing to execute a transaction. Exchange rules also prohibited any rebates of commissions to the customer. Under this regime, brokers sought to attract lucrative institutional business by offering various inducements to institutional customers. These included, particularly in the case of mutual funds, a willingness to give-up a portion of the commission to broker-dealers designated by the fund manage-

ment, who were engaged in selling fund shares. Such give-ups represented additional compensation to these dealers for their selling activities. The exchanges chose not to regard this as a rebate. While this practice was questionable and was abolished by the exchanges in December 1968, it was permitted prior to that time as a means by which fund managers could obtain something of value for their excess commissions.

In the over-the-counter market, no fixed commission rate was imposed. The National Association of Securities Dealers, Inc., the self-regulatory body for the over-the-counter market, was and is prohibited by law from maintaining fixed commission rates. The customer-directed give-up was not prevalent in that market and was, indeed, regarded as improper, if not illegal. As the Commission noted in December 1966

> "A directed give-up of a portion of the commission charged for handling a transaction for a fund in the over-the-counter market would be a patent waste of investment company assets." [37]

Respondents point to the fact that it was the usual practice in agency transactions in the over-the-counter market to charge the New York Stock Exchange commission rates. This appears to be correct.[38] The conclusion which respondents derive from this, that price competition for execution services did not exist in the over-the-counter market any more than in the exchange market, does not follow. Nor does it further follow that because give-ups were accepted in exchange transactions, they were therefore also acceptable in over-the-counter transactions.

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[37] Public Policy 178.

[38] *See Report of Special Study of Securities Markets of the S.E.C.*, H.R. Doc. No. 95, pt. 2, 88th Cong., 1st Sess. 624 (1963) (hereinafter cited as Special Study).

Although on small over-the-counter brokerage transactions the New York Stock Exchange commission was utilized as a familiar measure of a proper charge for the service, institutions were not required to, and usually did not, pay the high exchange commissions on large over-the-counter transactions. They simply dealt directly with over-the-counter market makers and were charged a mark-up substantially less than the applicable exchange commission.[39] Consequently, on institutional transactions in the over-the-counter market there were no excess commissions to be disposed of by using customer-directed give-ups, and customer-directed give-ups were not utilized in that market.

Respondents argue that because the Commission's 1967 consent order precluded IOS from dealing directly with market makers, the IOS-managed funds had to pay excessive commissions and IOS had to divert the excess into its own pocket. The Commission, of course, did not intend such a result, and the order clearly does not provide for such. Nothing in the 1967 order required the funds to pay, or Lipper to charge, excessive commissions.[40] If for any reason an institution wished to execute an over-the-counter trade with a broker-dealer firm as agent rather than as principal, this could be done, and the commission could be negotiated, as IOS and Lipper might have done here.

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[39] *Id.* at 627. But on the exchange, the transaction could not, of course, be executed for less than the minimum commission.

[40] Respondents appear to suggest that the practice of charging the stock exchange commission on over-the-counter transactions was not merely a practice, resorted to for convenience where appropriate, but rather reflected some type of agreement or conspiracy among broker-dealers to charge that rate under all circumstances. We can hardly assume the existence of such an agreement, particularly in view of the fact that, if practiced in the over-the-counter market where no statute affords the slightest justification for rate fixing, it would have been a flagrant violation of the antitrust laws.

Respondents claim to have relied on the advice of counsel, and they did have opinions of counsel which supported their course of conduct. Although neither ignorance of the law nor reliance upon counsel's opinions can make unlawful conduct legal, advice of counsel is often a weighty mitigating factor.[41] This is particularly true where the law is obscure or changing, or where the issues are technical and specialized, and a layman, therefore, requires the advice of counsel in order to chart a course.

But here the situation is different. The IOS respondents sought to divert the funds' money tc themselves, and the Lipper respondents knowingly participated in this effort. In doing so, they relied upon counsel's conclusion that they had discovered a loophole in the law of fiduciary responsibility. Counsel, in turn, relied upon the fact that no contested decision or rule was precisely in point and specifically prohibited respondents' scheme. This type of reliance is misplaced, particularly in the area of fraud. Moreover, counsel actually knew (not merely should have known) that this agency considered give-ups by brokers in over-the-counter transactions to be "improper and illegal."[42] Counsel apparently dis-

[41] An act done in reliance on the advice of counsel may nevertheless be "willful" within the meaning of that term as used in Section 15(b) of the Exchange Act. This is so because for purposes of that section "a violation is 'willful' whenever the actor intends to do the act that constitutes the violation without regard to whether he specifically intends to violate the law." *Gearhart & Otis, Inc.*, 42 S.E.C. 1, 28 (1964), *affirmed*, 348 F. 2d 798 (C.A.D.C., 1965). *See also Tager* v. *S.E.C.*, 344 F. 2d 5, 8 (C.A. 2, 1965).

[42] Public Policy 185. Respondents dismiss Public Policy as a mere essay that no one was obliged to heed. One part of that report dealt with the economics and the organizational patterns of the investment company business, as it was in 1966. Since those descriptions were based on exhaustive and protracted studies, we consider them authoritative. Another part of Public Policy—and the one pertinent here—contained a concise and carefully considered summary of this

agreed with these views. That was their privilege. But both counsel and their clients were aware of the risk, and they can hardly claim that they could not reasonably foresee that the loophole which they perceived might prove to be illusory.

B. *Jurisdictional Contentions*

Respondents assert that their over-the-counter give-up arrangements are outside the Exchange Act's purview. They advance two reasons to support their contention. One is that the charges against them have no real connection with the purchase or sale of securities, but are matters involving internal corporate affairs. The other is that what is involved here is so foreign as to make the laws of the United States inapplicable.

It is true that nothing falls within the ambit of Section 10(b) of the Exchange Act or of Rule 10b-5 thereunder unless it be "in connection with the purchase or sale of any security." It necessarily follows that there is an area of internal corporate management untouched by the Exchange Act's antifraud provisions.

These generalities, however, have no bearing on the case before us. This case deals with nothing but securities transactions and the securities business. The foreign funds were investors and traders in securities. Indeed,

Commission's understanding of the then existing law, the law as it already was, with respect to investment companies. A lawyer who told his clients that this was meaningless was counseling them to act at their peril. As the First Circuit said when it had, to consider Public Policy's impact on *Moses* v. *Burgin*, 445 F. 2d 369, 384 (C.A. 1, 1971), *cert. denied*, 404 U.S. 994 (1971): "Any contention that the Commission's views were offhand or . . . inconsequential . . . is, to put it bluntly, little short of extraordinary. We may add that . . . willingness to disregard the Commission itself casts some doubt on the bona fides of a claim that the earlier expressed views of the staff were ignored because of its inferior position."

that is all they ever did. The funds were constantly buying and selling huge blocks of securities. And they were continuously offering and selling their own shares to investors. Moreover, their shares were redeemable. Hence they were making continuing offers to repurchase their outstanding shares. In these circumstances we find it difficult to conceive of any significant aspect of their affairs that was not intimately connected with the purchase and sale of securities. We think it axiomatic that their expenditures for the brokerage services incident to such transactions were so connected.

Respondents support their contention that "foreign law rather than United States securities law is applicable" so that "the Commission is without jurisdiction or power over the allegations in this section of the order for proceedings" by pointing to Section 30(b) of the Exchange Act, which provides as follows:

> "The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title."

We note at the outset that § 30(b) does not speak of a business in securities "without the United States," but rather "without the jurisdiction of the United States." The Lipper respondents and IPC were conducting a substantial securities business in the United States. Moreover, the transactions of concern to us occurred in the United States. The Court of Appeals for the Second Circuit, in considering the reach of Rule 10b-5, has stated

that "the nation where the conduct occurred has jurisdiction to displace foreign law and to . . . apply its own."[43]

Lipper Corp. and IPC chose to register with this Commission as brokers and dealers. When they did that, they voluntarily subjected themselves and their businesses to the jurisdiction of the United States.[44] In view of their controlling influence over Lipper Corp. and IPC, Lipper himself and IOS were also transacting a securities business within the jurisdiction of the United States. Accordingly, this Commission concludes that it has jursdiction over the persons and the subject matter before it in this action.

C. *Other Matters*

The IOS respondents claim that the administrative law judge was disqualified because he reached certain conclu-

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[43] *Leasco Data Processing Equip. Corp.* v. *Maxwell*, 468 F. 2d 1326, 1339 (C.A. 2, 1972) (Substantial conduct within the United States warrants application of Rule 10b-5 to transactions on the London Stock Exchange in securities not traded on the American markets.) In *IIT* v. *Vencap, Ltd.*, 519 F.2d 1001, 1017 (C.A. 2, 1975) the Court of Appeals for the Second Circuit said: "We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners. This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States. By the same token it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country. . . ." And on that same day the court underscored this in the companion case of *Bersch* v. *Drexel Firestone, Inc.*, 519 F.2d 974, 987 (C.A. 2, 1975), where it said: "We are . . . holding . . . that Congress did not mean the United States to be used as a base for fraudulent securities schemes even when the victims are foreigners, at least in the context of suits by the SEC or by named foreign plaintiffs."

[44] "Jurisdiction for purposes of Section 30(b) does not mean territorial limits." *S.E.C.* v. *United Financial Group, Inc.*, 474 F. 2d 354, 357-358 (C.A. 9, 1973).

sions and made certain findings in his initial decision dealing with the Lipper respondents before he issued his initial decision about the IOS phase of the case. He issued separate decisions to accommodate the exigencies of a situation engendered by IOS and IPC. On representations that settlement with IOS and IPC was imminent, the administrative law judge closed the record without prejudice to an application to reopen it if IOS and IPC did not settle as anticipated. When no such settlement was reached, he reopened the hearings on the issues relating to IOS and IPC. Meanwhile, he issued an initial decision dealing with the Lipper respondents. No showing of actual bias or prejudice stemming from an extrajudicial source that would warrant disqualification was made. The administrative law judge's findings against Lipper and Lipper Corp. were made in the course of his official duties. And his initial decision in the Lipper case expressly pointed out that its findings were not binding on IOS and IPC. Hence he was not disqualified from subsequently deciding common legal and factual issues against IOS and IPC.[45]

VI. *REBATES OF BROKERAGE COMMISSIONS DERIVED FROM NEW YORK STOCK EXCHANGE TRANSACTIONS*

As previously noted, commissions on New York Stock Exchange transactions were, during the relevant period, divisible only among members of that exchange. Since neither IOS nor IPC was a New York Stock Exchange member, it would seem at first blush that there was no

[45] *Transamerica Corporation,* 10 S.E.C. 454, 473-474 (1941); *Kennedy, Cabot & Co., Inc.*, 44 S.E.C. 216, 223 (1970). *Cf. Federal Trade Commission* v. *Cement Institute,* 333 U.S. 683, 702-703 (1948); *United States* v. *Grinnell Corp.*, 384 U.S. 563, 582-583 (1966); *Lyons* v. *United States,* 325 F.2d 370, 375-376 (C.A. 9, 1963).

way in which they could derive direct pecuniary benefits from the New York Stock Exchange brokerage business placed by the IOS-managed funds. The IOS respondents, however, engaged in a scheme to obtain rebates of brokerage commissions paid on New York Stock Exchange transactions.[46]

The New York Stock Exchange commissions here under attack were paid by IPC's domestic fund, FOA, an investment company registered with us as such under the Investment Company Act.

The salient facts are these:

1. The IOS respondents gave some of FOA's New York Stock Exchange brokerage business to X Company, a New York Stock Exchange member firm. They did so because X Company had devised a technique for transmitting substantial chunks of excess institutional New York Stock Exchange brokerage back to the managers who placed orders with it.

2. X Company did not share the institutional New York Stock Exchange commission payments themselves with non-members. That would have been a blatant and an easily-detected violation of the New York Stock Exchange's anti-rebate rules. X Company's *modus operandi* involved the splitting of commissions generated by transactions in the over-the-counter market and on the Boston Stock Exchange.[47]

[46] The Lipper respondents have no connection with this aspect of the proceedings.

[47] X Company was a member of both the Boston and the New York Stock Exchanges. Like most other regional exchanges, the Boston Stock Exchange permitted its members to divide commissions with other professionals in the securities business, whether or not they belonged to it or any other exchange. *See* Public Policy 171; *Moses* v. *Burgin,* 445 F. 2d 369, 375-376 (C.A. 1, 1971) *cert. denied* 404 U.S. 994 (1971).

The institutional manager with whom those commissions were divided had no connection with, and had never even heard of, the over-the-counter and Boston transactions in question. X Company's clients in these trades were generally not institutions. Yet X Company was ready, willing, and able to send a stream of money arising out of these transactions to any institutional manager who placed New York Stock Exchange business with it.

3. The amount of money that the institutional manager could expect to receive from X Company was directly related to the amount of New York Stock Exchange business he gave it. Thus, for example, an FOA New York Stock Exchange trade that produced a $5,000 commission for X Company would be followed by a $2,500 check from it to IPC.

4. X Company, however, was not a large firm. Neither its over-the-counter nor its Boston volume was large enough to create a give-up pool sufficient in size to satisfy the IOS respondents' desire for commission money.

5. At this point, Y Company, another brokerage house, became involved. Y Company was not a New York Stock Exchange member. But it had developed an ingenious "new technique" for arranging give-ups. The key to the new technique was Y Company's membership on the American Stock Exchange. Now the simple two-sided arrangement of old was displaced by a triangular relationship among IPC, X, and Y, involving:

(a) The continued placement of FOA's New York Stock Exchange business with X Company—accompanied now, however, by the notation that the order had been placed with X Company, "courtesy of Y Company";

(b) X Company's placement with Y Company of enough American Stock Exchange business to produce net commissions for Y Company equal to the amount of the New York Stock Exchange commissions just paid by FOA to X Company;

(c) Y Company's subsequent disbursement of 52 percent of the commissions received from the American Stock Exchange business that X Company had forwarded to it to two of Y Company's registered representatives;

(d) The retention by those registered representatives of two percent of the aforementioned commissions to compensate them for their services as intermediaries; and

(e) The transmission of the 50 percent of these commissions to IPC so that the upshot of this series of maneuvers was the return to IPC of 50 percent of the commissions its *cestui que trust*, FOA, had paid X Company.

Since IOS and IPC were fiduciaries for the funds they controlled, neither of them was free to appropriate benefits derived from the execution of FOA's portfolio transactions for itself.[48] Of course, an investment company's manager may also be its broker.[49] When the manager acts as a broker, he is entitled to be paid for his work.[50] Here, however, neither IOS nor IPC ever supplied any broker-

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[48] *See Provident Management Corp.*, 44 S.E.C. 442 (1970); *Consumer Investor Planning Corp.*, 43 S.E.C. 1096 (1969).

[49] *See* Public Policy 71, 188-190.

[50] Section 17(e)(2)(A) of the Investment Company Act permits persons affiliated with registered investment companies and persons affiliated with such persons to receive "the usual and customary broker's commission if the sale is effected on a securities exchange."

age services to FOA. Hence this is a twice-told tale. In the New York Stock Exchange context with FOA's commissions, just as in the over-the-counter context with the foreign funds' commissions, the IOS respondents used their strategic position in, and controlling influence over, the funds to collect brokerage income from them without supplying any brokerage services in return.

We find, as did the administrative law judge, that the IOS respondents' activities in connection with FOA's New York Stock Exchange transactions were in willful violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. We affirm and adopt as our own his holding that:

> "No legal impediment precluded FOA instead of IPC from being the beneficiary of the arrangements. . . . [T]he arrangements . . . constituted a fraud upon FOA and its shareholders for which IPC, and IOS as a participant in the scheme, must be held accountable. It is also manifest from the record that IOS and IPC withheld details regarding arrangements that had been made for the benefit of IPC from FOA and its shareholders. Full and complete disclosure of that information was required of IOS and IPC in order to meet the fiduciary responsibilities that they had assumed by their active intervention in the management of FOA. The failure of the respondents in this regard can only be viewed as deliberate, and a deception that respondents felt necessary to the success of their scheme."

The IOS respondents argue that their conduct was justifiable under then existing industry practices and the New York Stock Exchange's rules. They claim that:

> 1. New York Stock Exchange anti-rebate rules made it impossible for FOA to benefit from the reciprocal payments.

> 2. Retail sellers of investment company shares commonly received reciprocal income from the funds' portfolio brokerage transactions.
>
> 3. The reciprocal income paid IPC, and through it to IOS, was simply additional compensation for IPC's services as the principal retail distributor of FOA's shares.
>
> 4. Both IPC and FOA would have been at a competitive disadvantage vis-a-vis other mutual funds and other mutual fund managers, had they been precluded from paying and receiving reciprocal income.

These contentions are without merit.

We begin by assuming *arguendo* that what respondents say about the impact of the New York Stock Exchange's anti-rebate rules is correct. On that assumption, no direct pecuniary benefits could have been passed back to FOA. Hence the IOS respondents had to choose between letting New York Stock Exchange members keep all of the commissions or devising some plan by which they, the respondents, could share in them.

Even if that had been the situation, respondents would not have been privileged to do as they did. True, direct price competition among exchange members was suppressed. But it does not follow that there was no competition at all among exchange members. The sellers of New York Stock Exchange brokerage services were, in fact, in vigorous non-price competition with each other. In the institutional sphere, that non-price competition took several forms. One most significant form was a competition in supplying services to the institutions. Investment research was the principal form of such service.[51]

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[51] *See* Public Policy 163-164.

In the circumstances of this case, the IOS respondents were under a duty to deploy FOA's excess brokerage or "brokerage power" for the fund's benefit, not theirs. It follows that, if they had the capacity to cause any part of the commissions to leave the hands of the executing broker, they were bound to use that part to buy research and related services of value to FOA's shareholders. When respondents entered into their kickback arrangements with X and Y, they breached that duty. Those arrangements were of great benefit to respondents. But they did nothing at all for FOA. To the extent respondents chose to induce the executing broker to give up a portion of the commissions, they could not cause it to benefit themselves in preference to FOA.[52]

The rules of the New York Stock Exchange provide no more justification for the IOS respondents' retention of a portion of the commissions on the New York Stock Exchange transactions than they did on the over-the-counter transactions previously discussed. IOS and IPC were neither members of the New York Stock Exchange nor subject to its rules. And even if they had been, nothing in those rules would have compelled them to keep this give-up money for themselves. These are what we deem the controlling considerations:

1. Complex reciprocal and give-up arrangements, such as those that were entered into here, were designed for the very purpose of avoiding the New

[52] The peculiarities of the investment company context call for standards higher, not lower, than those that prevail elsewhere. *Cf. Brown* v. *Bullock*, 194 F. Supp. 207, 233 (S.D.N.Y., 1961), *affirmed* 294 F.2d 415 (C.A. 2, 1961): "In light of the distinctive character of investment companies and their easy susceptibility to management abuses (e.g., looting of the companies by insiders using means both crude and subtle), one of the primary objectives of the 1940 Act was the protection of investment companies as well as investors against the derelictions of investment companies' directors, investment advisers, other fiduciaries, and principal underwriters."

York Stock Exchange's anti-rebate rules. The over-the-counter markets and the regional exchanges were brought into the picture because the New York Stock Exchange had no more than the most peripheral sort of control, if that, over the economic aspects of its members' activities on those markets.[53]

2. The New York Stock Exchange did not object to arrangements under which excess brokerage stemming from transactions on its floor was used to reduce an investment company's advisory fee. Hence it would have been quite easy to give FOA the benefit of these give-ups. But respondents had no desire to do that.

3. Unlike the New York Stock Exchange, six of the seven regional exchanges permitted non-members who were professionals in the securities business to share in commissions arising out of transactions executed on them.[54]

Respondents' argument that the give-ups in question are analogous to those that were common in the invest-

[53] As of the 1963 Special Study pointed out: "Return by an NYSE member of cash to his reciprocal correspondent for commission business would violate the anti-rebate rule . . ., but the return of a cash equivalent in the form of profitable security commission business which might have been transacted directly by the NYSE member is permissible . . . . The Exchange's published constitution and rules have never officially recognized a need to regulate reciprocal commission arrangements. Its rule 369 outlaws 10 specific commission practices either outright or under specified conditions, but does not mention reciprocal arrangements with non-member professionals." H.R. Doc. No. 95, pt. 2, 88th Cong., 1st Sess. 304.

[54] Public Policy 171-173. "It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds." *Id.* at 173. *See also Moses* v. *Burgin*, 445 F. 2d 369, 375 (C.A. 1, 1971), *cert. denied* 404 U.S. 994 (1971).

ment company industry during the relevant period is misplaced. As the owner of FOA's investment adviser and manager and as the principal underwriter of FOA's shares, IPC's position was in no way comparable to that of a mere retail seller of fund shares to whom the adviser-underwriters of the various funds whose shares he sold directed reciprocal brokerage income by way of give-ups in order to provide an additional incentive to sell their shares. IPC was a fiduciary for FOA and its shareholders. The ordinary retail dealer is a merchant of mutual funds shares; no fiduciary relationship exists between him and his merchandise.

A mutual fund's adviser-underwriter needs no special incentive to promote the sale of shares in his own funds. His advisory fee supplies him with sufficient motive. And unlike the independent retail dealer, the adviser-underwriter has the entire sales charge at his disposal. Moreover, he has voluntarily bound himself by contract to exert his best efforts to promote the sale of the fund's shares.

To the independent retail dealer, on the other hand, the hundreds of mutual funds promoted and managed by the various competing adviser-underwriters present a wide choice. Within a broad area, he has no special reason to prefer to sell the shares of Fund Complex A rather than Fund Complex B. Hence the adviser-underwriters who sold through retail dealers were under strong competitive pressure to reward those dealers with give-up money.[55] The sale of FOA shares was already attractive to the IOS respondents. There was no need to make it

[55] Public Policy 170: "The customer-directed give-up has been used extensively by the funds. It permits them to entrust the execution of their portfolio transactions to a selected few brokers in whom they have special confidence and to reward with substantial cash payments the far larger group of brokers that distribute their shares."

even more attractive.[56] We think it clear that the give-ups in question were not engendered by competitive exigencies.[57]

The IOS respondents assert that the FOA brokerage arrangements were adequately disclosed in its prospectuses. We see no substance to this disclosure claim.[58] We are in full accord with the administrative judge's holding that FOA's prospectuses were inadequate and misleading.

The prospectuses made various statements about brokerage and about the basis on which brokers were selected. Those statements were more or less standard in the mutual fund prospectuses of those days. Although they could have been sharpened to some extent, they did say that FOA might give its brokerage business to those who sold its shares. They also said that brokerage might be allo-

[56] A high IOS official testified: "I very strongly urged [that] the firm 'profitability-wise' [would realize] much more residual benefits for the years to come through the building of a management fee than selling other people's funds even at maximum commission rates. I wasn't alone. . . . [E]verybody recognized that."

[57] Respondents' counsel treat the distinction between the adviser-underwriter who directed give-ups to unaffiliated retail dealers and their clients who directed give-ups to themselves as a distinction without a difference. We disagree. We see a very real difference between the two situations. It is true that the adviser-underwriters who scattered give-up largesse among hosts of retail dealers did so out of self-interest. By treating those dealers generously, the adviser-underwriter encouraged sales, thereby enhancing the size of the fund and his management fee. But IPC did not rely to any appreciable extent on independent dealers. It had its own sales force. And as a fiduciary, it could not retain any part of the give-ups.

[58] Respondents say that they were not responsible for FOA's prospectuses. In view of their control over every aspect of FOA's affairs and of the fact that the FOA prospectus was on at least one occasion amended to accommodate them, we must reject their claim.

cated "at the request of dealers including the Principal Distributor."

These "disclosures" certainly did not inform the ordinary investor that respondents were deriving direct cash benefits from FOA's brokerage without doing any work in exchange for those benefits. A prospectus must be clear and candid.[59] And FOA's prospectuses were at best murky and ambiguous. In their last brief to us, IOS respondents themselves concede that 'in hindsight' the "disclosures may appear . . . overly cryptic."[60]

Respondents state that IPC collected $297,422 from X Company and Y Company as its share of FOA's New York Stock Exchange portfolio brokerage commissions. IPC ultimately returned this money to FOA. But it did not do so until after our staff had raised questions about the matter and had made it plain that it considered restitution the appropriate course. A refund made under such

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[59] *See, e.g., Franchard Corp.*, 42 S.E.C. 163, 184 (1964) and cases there cited. *See also The Wolf Corp.*, 42 S.E.C. 1042, 1049 (1966): "The Act required a clear and uncomplicated statement in the prospectus of the basic facts."

[60] Respondents argue that the disclosures in the prospectuses must have been adequate because our staff "cleared" them. There is no substance to that argument. To begin with, there is nothing in the record that even suggests that our staff knew that the prospectuses were supposed to disclose that the IOS respondents were taking FOA's excess brokerage. Secondly, "The burden of seeing to it that a registration statement filed with us neither includes any untrue statement of a material fact nor omits to state any material fact required to be stated therein or necessary to make the facts therein not misleading always rests on the registrant itself, and it never shifts to our staff." *Doman Helicopters, Inc.*, 41 S.E.C. 431, 441 (1963). Thirdly, there can be no such thing as an estoppel against the Government in circumstances such as these *Boruski* v. *S.E.C.*, 289 F. 2d 738, 740 (C.A. 2, 1961); *S.E.C.* v. *Culpepper*, 270 F. 2d 241, 248 (C.A. 2, 1959); *S.E.C.* v. *Morgan, Lewis & Bockius*, 209 F.2d 44, 49 (C.A. 3, 1953).

circumstances is no defense to the violations charged. And its mitigative weight is minimal.[61]

The above-described conduct with respect to FOA constituted a willful violation by IPC, willfully aided and abetted by IOS, of Section 17(e)(1) of the Investment Company Act.[62] As pertinent here, that section makes it unlawful for any affiliated person of a registered investment company, or any affiliated person of such person, "acting as agent, to accept from any source any compensation . . . for the purchase or sale of any property to or for such registered company . . . except in the course of such person's business as an underwriter or broker." IOS and IPC were affiliated persons of an affiliated person of FOA. And they also had the power to make FOA's investment decisions and to direct its portfolio transactions. Accordingly, they were "acting as agent" within the meaning of Section 17(e)(1).[63] Neither of them ever performed any brokerage or underwriting services in connection with the purchase and sale of FOA's portfolio securities. Those securities were FOA's "property" within the meaning of Section 17(e)(1).[64] Accordingly, the re-

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[61] As we said in *Richard K. Fudge*, 30 S.E.C. 334, 339 (1949): "While restitution to defrauded persons is to be encouraged, we cannot, on that basis alone, permit violators to escape the consequences of their acts, particularly when restitution comes after discovery of their misdeeds." The significance of the refund to FOA is further diminished by the fact that no part of the far larger sums ($1,450,000 as against $297,422) derived from the foreign funds' over-the-counter brokerage commissions was ever returned to those entities.

[62] As we have seen, unlike the foreign funds, FOA was a registered investment company.

[63] *Cf. United States* v. *Deutsch*, 451 F.2d 98, 109-111 (C.A. 2, 1971) *cert. denied*, 404 U.S. 1019 (1972).

[64] Id. at 114. *See also Provident Management Corp.*, 44 S.E.C. 442, 448 (1970); *Consumer-Investor Planning Corp.*, 43 S.E.C. 1096, 1101 (1969).

tention of the reciprocal benefits derived from FOA's portfolio transactions was an impermissible form of compensation proscribed by Section 17(e)(1). As affiliated persons who were not acting as brokers for FOA, IOS and IPC were subject to the prohibitions of Section 17(e)(1).[66]

Violations of other sections of the Investment Company Act flow from the findings of violations of the antifraud provisions and the provisions of Section 17(e)(1). Thus, FOA's advisory contract failed to disclose, as required, that its manager's compensation would include payments to IPC attributable to the allocation of brokerage on FOA portfolio transactions. The proxy solicitation material used in connection with the March 1967 FOA stockholders' meeting and filed with us, and the April 1967 prospectus of FOA also filed with us, failed adequately to disclose that IPC would derive reciprocal income from the allocation of brokerage at its request and the inherent conflicts of interest detrimental to FOA. Under the circumstances, we conclude that IOS and IPC, which controlled FOA, willfully violated or willfully aided and abetted violations of Sections 15(a)(1), 20(a) and 34(b) of the Investment Company Act and Rule 20a-1

[66] As the Court of Appeals for the Second Circuit held in *United States* v. *Deutsch*: " '[A]cting as agent' is . . . a descriptive phrase distinguishing affiliated persons acting as brokers from those who are not acting as brokers in connection with a sale or purchase of securities for an investment company." 451 F. 2d at 111. As one commentator observes: "Section 17(e) is basically an anti-kickback provision. Its proscriptions apply when the affiliated person (or an affiliated person thereof) acts as an 'agent'; when the money received constitutes 'compensation'; and the activities giving rise to the compensation are not within 'the course' of the affiliated person's 'business as an underwriter or broker'." Butowsky, *Mutual Fund Brokerage*, 3 Rev. of Securities Regulation 915 (1970).

thereunder.[66] Those respondents also willfully aided and abetted violations of Section 31(a) of the Investment Company Act and Rule 31a-1(b)(9) thereunder, in that through the concealment of such information, they caused FOA to maintain records which did not accurately reflect, as required, the basis for allocating its portfolio orders and the division of compensation on such orders.

VII. *THE PUBLIC INTEREST*

A. *IOS*

IOS is a shambles today. There is little reason to believe that it has any appreciable power to inflict further harm on investors. Nevertheless, we agree with the administrative judge that it is in the public interest to bar IOS from association with any broker or dealer.[67] That conclusion rests on two grounds.

The first relates to the gravity of IOS's willful violations. When misconduct is as serious and as pervasive as that of IOS in this case, we think the burden is on the respondent to show us why something less than a total

[66] Section 15(a)(1) prohibits a person from serving as an investment adviser of a registered investment company in the absence of a written contract precisely describing all compensation to be paid thereunder. Section 20(a) and Rule 20a-1 prohibit solicitations of proxies by means of a proxy statement containing any false or misleading statement of a material fact. Section 34(b) contains a similar prohibition with respect to documents filed or transmitted pursuant to provisions of the Investment Company Act.

[67] *See Globe Aircraft Corp.*, 26 S.E.C. 43 (1947) where we issued a stop-order suspending the effectiveness of a Securities Act registration statement even though the issuer had been adjudicated a bankrupt so that the possibility of future trading in the registered securities was extremely remote. We did so because we considered a "stop-order . . . a necessary corollary of our finding that the registration statement is false and misleading" and because we viewed such an order as the appropriate "means of formally terminating the effectiveness of the misleading document." 26 S.E.C. at 55.

bar would be appropriate. No such showing having been made, anything short of a total bar would be inappropriate."

Secondly, we must weigh the effect of our action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally. If these proceedings are to be fully remedial, they must have a deterrent effect on other investment company managers who may be tempted to enrich themselves at the expense of their beneficiaries." We think that a total bar is necessary to provide the deterrent effect.

B. *IPC*

IPC's case differs materially from IOS's. IPC was a mere instrumentality. It was never an independent actor. Moreover, its present owners are wholly unaffiliated with IOS. It follows that a sanction against IPC could not possibly tend to achieve any remedial purpose. We therefore find it in the public interest to discontinue the proceedings, so far as they relate to IPC.

C. *Lipper Respondents*

In his initial decision the administrative law judge said that the Lipper respondents' violations "were serious and long continuing." He also found that:

> "Lipper . . . did nothing to ameliorate [the] fraudulent practice until his own . . . financial success

" Our 1967 order requiring IOS to conduct all its securities activities outside the United States does not warrant a different result. That order was in the nature of a resignation by IOS as a part of a settlement of charges based on entirely different facts. It can neither be equated with nor viewed as a substitute for a bar order predicated on findings of fact such as those made in this opinion.

" *Beck* v. *S.E.C.*, 430 F. 2d 673 (C.A. 6, 1970) is inconsistent with these views. But we respectfully disagree with the holding of that case and decline to follow it.

> [was] assured. The picture that emerges from the record is of a man intent on personal gain and willing to take the risk that the scheme by which he could reach his goal would not be found illegal."

In spite of these considerations, the administrative law judge thought twelve-month suspensions appropriate. He saw no likelihood that the Lipper respondents' misconduct would be repeated. And he viewed the unfavorable publicity that they had already received because of the institution of these proceedings as being in itself a sanction of some severity.

The administrative judge is an adjudicator of long experience and great acumen. Hence we have considered his views with special care. We are, nevertheless, constrained to reject them. As we see it, the Lipper respondents were as culpable as IOS. In situations of this sort, the remitting broker and the receiving institutional manager are acting *in pari delicto*. Neither can accomplish his ends without the other. We cannot be as sanguine as the administrative law judge about future derelictions of this sort by the Lipper respondents. What we have before us is not some isolated indiscretion. Lipper Corp. owed its existence to IOS. And the Lipper-IOS relationship was rooted in the over-the-counter give-ups that flowed from Lipper to IPC.

Congress, in writing Section 15(b) of the Exchange Act, viewed past misconduct as the basis for an inference that the risk of probable future misconduct was sufficient to require exclusion from the securities business. Having been directed by the Act to draw that inference whenever our discretion leads us to consider it appropriate," we

" *See A. J. White & Co.*, Securities Exchange Act Release No. 10645, pp. 5-6 (February 15, 1974), 3 SEC Docket 550, 551-552; *Foelber-Patterson, Inc.*, 12 S.E.C. 330, 336 (1942).

must do so if the legislative aim is to be attained."[71] We think the likelihood of future misconduct by the Lipper respondents sufficient to call for their exclusion from the securities business."[72] Moreover, as we have indicated in discussing IOS, that sanction will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers.

VIII. *CONCLUSION*

Our order will:

1. Bar IOS from association with any broker or dealer;

2. Discontinue the proceedings with respect to IPC;

3. Revoke Lipper Corp.'s broker-dealer registration;[73] and

4. Bar Arthur Lipper, III from association with any broker or dealer.[74]

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[71] In the securities business opportunities for dishonesty recur constantly. This necessitates specialized legal treatment. *See Archer* v. *S.E.C.*, 133 F. 2d 795, 803 (C.A. 8, 1943), *cert. denied* 319 U.S. 767 (1943); *Hughes* v. *S.E.C.*, 174 F. 2d 969, 975 (C.A.D.C., 1949).

[72] This is so even though it appears that some years have now elapsed since they were last engaged in the securities business. That obviated any need for speedy action by us. However, the Lipper respondents are still legally free to engage in the securities business. Since we believe that this would be incompatible with the public interest, we are constrained to take appropriate preventive action.

[73] Lipper Corp. has applied for the withdrawal of that registration. Since we find revocation the appropriate course, we shall deny that request.

[74] The exceptions to the initial decision are overruled or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.

By the Commission (Chairman GARRETT, Commissioners LOOMS, EVANS and SOMMER), Commissioner POLLACK not participating.

/s/ GEORGE A. FITZSIMMONS
George A. Fitzsimmons
Secretary

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

Securities Exchange Act of 1934
Rel. no. 11773/October 24, 1975

Admin. Proc. File Nos.
3-2156 and 3-2157

In the Matters of

ARTHUR LIPPER CORPORATION
140 Broadway
New York, New York
(8-13182)

ARTHUR LIPPER, III
IOS, LTD. (S.A.)
Geneva, Switzerland

INVESTORS PLANNING CORPORATION OF AMERICA
(now known as CIP, Inc.)
New York, New York
(8-12374)

Order Imposing Remedial Sanctions and Discontinuing Proceedings

On the basis of the Commission's opinion issued this day it is

ORDERED that IOS, Ltd. (S.A.) be, and it hereby is, barred from association with any broker or dealer; and it is further

ORDERED that Arthur Lipper Corporation's request for the withdrawal of its registration as a broker and dealer be, and it hereby is, denied; and it is further

ORDERED that Arthur Lipper Corporation's aforementioned broker-dealer registration be, and it hereby is, revoked; and it is further

ORDERED that Arthur Lipper, III be, and he hereby is, barred from association with any broker or dealer; and it is further

ORDERED that the proceedings with respect to Investors Planning Corporation of America, now known as CIP, Inc., be, and they hereby are, discontinued.

By the Commission.

/s/ GEORGE A. FITZSIMMONS
George A. Fitzsimmons
Secretary

STATUTE AND RULES INVOLVED

Section 10(b) of the Securities Exchange Act of 1934 states:

Regulation of the Use of Manipulative and Deceptive Devices

Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange——

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 thereunder states:

> Rule 10b-5. Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.